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DUFAS consultation reaction on the EC proposal on the AIFMD Review of 25 November 2021

To	European Commission
From	DUFAS (the Dutch Fund and Asset Management Association)
Date	23 March 2022
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Executive summary

DUFAS welcomes the European Commission's (EC) review of the Alternative Investment Fund Management Directive (AIFMD) and its aim to set out targeted improvements to key provisions in the current framework. DUFAS however, wishes to emphasize that although the proposed amendments to the AIFMD do not introduce wholesale changes to the framework, there are some important amendments to key areas that warrant close attention.

Firstly, DUFAS would like to repeat our request to expand the ***ancillary services*** that AIFMs can provide with client order execution as we see no specific reason why this is not allowed under the AIFMD. We are convinced of the fact that such expansion will lead to increased cost efficiency and that it will not negatively impact investor protection.

With regard to the proposed amendments regarding ***Liquidity Management Tools (LMTs)*** DUFAS worries about the possible consequences of too much of an interventionist approach by ESMA when establishing the level 2 specifications. DUFAS wishes to emphasize that the fund manager's knowledge of their fund is essential to effective liquidity management thereof. Therefore, we would like to stress the importance of maintaining the fund manager's discretion as to when certain LMTs should be triggered because overruling their assessment thereof might bring about negative implications for financial stability and investor protection.

The proposed provisions on Loan Originating Funds (LOFs), partly incorporated under the liquidity provisions in the EC-proposal, warrant extra attention as they will have a disastrous impact on the Dutch micro-finance and green funds. As these are the funds that already implement the most important Capital Markets Union (CMU) and Sustainable Finance objectives in practical terms, and have been doing so for quite some years already, DUFAS and its members are worried that the EC's proposal will prove extremely counterproductive in this area. We would therefore like to suggest that if the EC foresees problems with LOFs on liquidity, it should seek to solve these through more specific liquidity rules – not with a mandatory closed-end status. Alternatively, a threshold of at least 85% or even exemption of microfinance and green funds from the 60% threshold provisions might be considered.

Furthermore, DUFAS would like to ask for the EC to provide definitions in the proposal for 'loan' and 'loan origination' in order to limit room for interpretation regarding these requirements. DUFAS would also like to ask for further clarification concerning the level at which the 20%-limit for lending to a single borrower should be assessed, the provisions regarding the application date of the aforementioned limit and whether the proposed risk retention (of 5%) will apply per loan and what this implies for loans which can only be transferred in their entirety.

The proposed stipulations regarding ***delegation*** should, according to DUFAS, only apply to tasks for which the AIFM bears direct or, better yet, legal responsibility. DUFAS therefore suggests an amendment be made to the recitals to further specify. DUFAS would also like to suggest excluding intra-group delegation from the scope of the proposal. In addition, as delegation to third country entities will be subject to increased reporting and, probably after establishing level 2 requirements, additional supervisory scrutiny, DUFAS worries that these stipulations will add to the already impressive reporting burden of AIFMs. We would therefore like to ask for fact finding by NCAs through the regular information as already obtained from the AIFM in the field of delegation.

With regard to the proposed amendments to the ***(supervisory) reporting requirements***, DUFAS asks for a better coordination between relevant authorities in order to prevent the same data being requested by different supervisors. In addition, DUFAS also notices that certain provisions and terms on reporting are reframed in the proposal in a way that implies broader reporting requirements and that there are provisions scattered throughout the proposal about improving or expanding reports that will also increase aforementioned reporting burden on AIFMs. DUFAS is of the opinion that extending the reporting requirements will probably lead to overshooting and that a proper interpretation of the data by the authorities will become more difficult and time-consuming because of it.

Furthermore, DUFAS sees the proposed stipulations regarding ***disclosure*** as unnecessary as the already existing disclosure requirements for AIFs, also stemming from both the PRIIPs regulation and MiFID, can be seen as sufficient and thus allowing for investors to make an informed investment decision. It is also important to note that the proposed frequency for reporting - on a quarterly basis – implies that calculation of fees would have to be based on estimates.

Given the practical consequences of the proposed changes, ***grandfathering provisions*** are needed throughout the proposal according to DUFAS. We also note that the subsequent enactment of delegated acts will impact the operation of a number of the provisions, therefore we would like to suggest that it be specified that those provisions only come into effect after the publication of the final level 2 and 3 texts.

Introduction

DUFAS welcomes the EC's review of the AIFMD and its aim to set out targeted improvements to key provisions in the current framework in line with further movements towards a European Capital Markets Union (CMU). DUFAS however, wishes to emphasize that although the proposed amendments to the AIFMD do not introduce wholesale changes to the framework, there are some important amendments to key areas that warrant close attention according to DUFAS and its members.

With regard to the various issues identified, DUFAS would then like to bring the following to the attention:

Addition of order execution to the list of ancillary services

DUFAS welcomes the addition of two investment services in the proposal, however, in our opinion the ancillary services that AIFMs can provide should also be expanded with client order execution. For the following reasons, we believe that it would be beneficial for the wider market if the MiFID investment service 'execution of orders on behalf of clients' would be added to the list of permissible activities for a regulated AIFM:

- As far as we can establish there seems to be no specific reason why 'execution of orders' was not allowed under AIFMD other than that this was not an activity that many fund

managers employed, and therefore there was no demand for this. DUFAS agrees that this made sense at the time, but does believe that if this is the reasoning, it might be time to reconsider;

- It was very much market practice to trade by voice when AIFMD entered into force, but as a result of technological developments, the market is moving more and more to on-screen trading on multilateral trading facilities (MTF's). This is generally considered to be beneficial, as it leads to market efficiencies and reduced brokerage costs. Often buy-side parties can now trade directly on an MTF, no longer needing a broker to access such markets. From a regulatory perspective this means that the qualification of the service the buy-side party provides shifts from receive and transmit orders to third parties (RTO) to execution only (EXO). We doubt whether the current regulatory consequences hereof, particularly for AIFMs, is justified, considering the lack of any meaningful practical difference. Adding 'execution of orders' to the list of permitted activities by AIFMs could therefore be seen as a way of keeping the regulatory landscape aligned with market developments rather than an expansion of activities per se;
- In line with the market developments highlighted above, having the possibility to enter into a transaction on behalf of clients on an MTF rather than through voice trading is, according to DUFAS and its members, beneficial from a best execution perspective, and therefore benefits clients of AIFMs;
- In the European Union (EU), the legislator seems convinced of the benefits for end clients and the markets in general if as many as possible trades are executed on venue. As a result hereof, MiFID II/ MiFIR contains a share trading obligation and derivatives obligation, resulting in the fact that certain shares as well as liquid derivatives should be traded on a trading venue. The scope of products covered seems to be expanded under the most recent draft of MiFIR. Particularly with respect to derivatives, these transactions often take place on MTFs. It seems inefficient if AIFMs are not allowed to access such MTFs directly, but have to appoint a broker to do so. This offers no upside for the AIFM's clients, whereas it does result in additional costs.

The reason why we plead for this change all comes down to providing the best services for our members' clients. This also implies that DUFAS members feel that their investors should always be sufficiently protected. Given the fact that AIFMs tend to only provide MiFID services to professional clients and the fact that when providing these services the relevant MiFID rules apply, we believe that the addition of 'execution of orders' to the list of permissible activities does not lead to reduced investor protection.

Regarding Liquidity Risk Management Tools

Liquidity risk management tools (LMTs) are mandated to be made available to AIFMs and are listed in the new Annex V. Asset managers will have to select and include at least one of three pre-selected tools in the fund instruments of incorporation, they can choose to select additional tools from the list as well.

DUFAS welcomes the proposal to make available these LMTs across all Member States. However, we worry about the possible consequences if too much of an interventionist approach is chosen by ESMA when establishing the required regulatory technical standards (RTS). As ESMA is granted a mandate to develop these RTS for the selection and use of LMTs while also addressing appropriate disclosures to investors and reducing undue advantages for first redeemers, DUFAS would like to caution for overly-prescriptive specifications therein.

DUFAS is of the opinion that the fund manager's knowledge of the liquidity profile of their fund, its investor base and the underlying assets and related markets, is essential to effective liquidity management. Therefore, we would like to stress the importance of maintaining the fund manager's

discretion as to when certain LMTs should be triggered because overruling their assessment thereof might bring about negative implications for financial stability and investor protection and could thus even prove pro-cyclical.

With regard to the power of national competent authorities (NCAs) to request the activation or deactivation of the LMTs as specified in the new article 46(2j), DUFAS notes that NCAs already have the power to suspend redemptions. DUFAS would like to caution against expanding this power to further LMTs other than redemption gates, and therefore asks for a re-evaluation of the current wording of article 46(2j). As noted above, we consider the discretion and knowledge of the fund manager as key to effective liquidity management – also from a broader perspective. Any role for NCAs to activate an LMT in place of the manager should thus be permitted only on the basis of consultation with the fund manager and in extraordinary circumstances of imminent and closer defined systemic risk.

The European Systemic Risk Board (ESRB) has recommended to consider the possibility for supervisors to force the activation of a suspension of redemptions, subscriptions or a gate, even if those particular LMTs are not included by the fund in its incorporation documents. DUFAS would like to strongly caution against such an approach as we are of the opinion that if this were to be allowed for, it would negatively impact investors' legal certainty.

Liquidity requirements for open-ended Loan Originating Funds

We understand the EC's concern from a liquidity perspective on open-ended AIFs, and fully agree that for investor protection it is crucial that when a fund is open-ended, be it UCITS or AIF, investors can exit such a fund. We do, however, not agree on Article 16(2a) regarding the 60% limit for loans in open-ended funds, as we think any issues there should be addressed in and with liquidity-management rules – and not with a limit which triggers closed-end status. DUFAS thereby wishes to draw attention to the EC/694/2014 framework which expressly states that a fund is open-ended if (in essence) the manager or its documentation say so, and exit is guaranteed at certain dates arranged for in procedures which are part of liquidity management.

The notion behind proposing the 60%-limit seems to be that the activity of loan-origination and having loans as assets in a fund, imply per definition that the fund has illiquid assets which a liquidity management framework can't manage. DUFAS thinks this notion is not correct and we would like to bring to the attention that in the Netherlands many open-ended AIFs have existed for many years. These are loan originating (microfinance) funds, open-ended and for retail, which have never been closed for exits for liquidity reasons. We would therefore like to suggest that if the EC foresees problems with loan originating funds on liquidity, it should seek to solve these through more specific liquidity rules – not with a mandatory closed-end status.

DUFAS would like to draw attention to the fact that if the threshold of 60% is maintained, this will mean that current successful microfinance and green funds will cease to exist as many have a loan portfolio of more than 60% needed for their business model, and in order to apply adequate diversification within the loans[1]. Therefore and alternatively, if the EC really needs to impose a limit, we would like to propose a higher limit of at least 85%.

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[1] Please note that the total market size of open end private debt AIFs in the EU is estimated by ALFI at EUR 40/bln AuM (and with that it eclipses the market for ELTIFs, estimated by the EC to be around EUR 2.4/bln AuM): https://www.alfi.lu/getattachment/4ade2c61-d64d-40c6-b38c-627386bb9638/app_data-import-alfi-private-debt-fund-survey-2021.pdf . We are aware of microfinance funds and green funds for retail investors are offered by among others LuxFlag, Incofin, RESPA, Blue Orchard, ASN Impact Investors, Triodos Investment Management. The last two mentioned parties are a members of DUFAS.

DUFAS would like to stress that the implications of the currently proposed limit are the following:

- If retail-AIFs that invest in originated loans are to be closed-end, this implies a major loss of diversity and with that resilience of the EU's financial markets;
- There will be no liquidity for retail investors until the "end" of the fund, while existing funds have shown adequate liquidity for over 20 years, including during several shocks;
- There will be limited access for citizens to LOFs as banks will choose to no longer distribute them, since banks are typically reluctant to offer open-ended funds to retail clients;
- The aforementioned also implies that these AIFs are then only available for high end investors, i.e. family firms and (ultra) high net worth individuals, who directly trade with the AIFM and not via a distributor;
- This also means that the recent successful growth in banks offering impact funds (for renewable energy, micro-finance, and innovations) in their private banking menu will be nullified;
- A higher risk for retail investors is also implied: if funds decrease the amount of loans in the fund in order to stay below the 60%-threshold, and therefore increase the amount of equity, this will increase the risk profile of the fund. Moreover, banks will not want to distribute multi-assets funds for their complexity, so the proposal will in practice eventually only allow for equity-only retail-AIFs;
- Ultimately, this means less investment in social and environmental impact: if these funds cannot be distributed widely, less fund managers will choose to invest in the underlying SMEs. According to DUFAS these are typically the type of SMEs which are crucial for the transition, as it involves both high impact innovative environmental entrepreneurs and social enterprises that ensure the supporting fabric of communities and increase resilience. As may be assumed, banks are rather hesitant to provide such parties with loans as these types of loans are associated with a higher level of risk weighted assets on their balance sheet;
- According to DUFAS it will in practice leave only two choices for retail investors: 1.) either to invest in (more volatile) listed securities or 2.) engage in (very high risk) crowd-funding. With that, significant parts of the retail market will be left out of safer investment options;
- It will also lead to marginalization of the potential market for eco-labelled retail-funds, leaving investors wanting to invest in ESG activities close to home and heart without this option.

The current proposal with regard to the 60%-limit on loans in open-ended funds will therefore in DUFAS' view make the EU a riskier place for retail investors to save and invest long-term in SMEs through investment funds. As the proposed changes to the ELTIF Regulation do not include an amendment to article 18 of said regulation, leaving the requirements regarding the closed-end status of ELTIFs intact, this regime also doesn't offer an alternative for current microfinance and green AIFs.

Policy recommendation

DUFAS acknowledges that available liquidity is a crucial requirement for retail investment in general. We recognize that many retail AIFs across the EU manage the liquidity of their funds with revolving finance, i.e. incoming and outgoing pipelines of granted and repaid loans, while always keeping part of the fund in liquid securities.

According to DUFAS however it is important to realize that– other than UCITS which trade daily and therefore need sufficient liquidity on a daily basis – AIFs with an 'open-end' status can also trade only weekly, monthly or even quarter-yearly. In that sense there is a wide gap between a (daily) open-end UCITS, and a closed-end AIF. It seems this hasn't been taken into account while drafting the AIFMD review-proposal. Under current EU law, the choice of frequency of trading lies with the AIFM. The latter decides depending on the type of assets involved – and to fit the type of assets.

Even having said that a lesser frequency is an option for an open-ended AIF, it should be noted that the two biggest Dutch green funds which are LOFs (Triodos Green fund and ASN Microkredietfonds) are both traded daily and have always assured adequate liquidity for their (retail)investors.

As article 2 of EU/694/2014 puts it:
'An AIFM of an open-ended AIF shall be considered to be an AIFM which manages an AIF the shares or units of which are, at the request of any of its shareholders or unitholders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down, directly or indirectly, out of the assets of the AIF and in accordance with the procedures and frequency set out in its rules or instruments of incorporation, prospectus or offering documents.'

Thus, a solution that would do justice to both the required safety for retail investors and the diversity of the investment products with which citizens can engage in themes and undertakings that appeal to them, would be in the liquidity management requirements in combination with the frequency of trading, that fit the investments in the particular AIF.

As a solution, if more protection for investors is required, a further specification of EU/694/2014 could be proposed according to DUFAS:

a.) to require LOFs that exceed the 60% threshold to regulate liquidity, e.g. by requiring 5% of assets to be held in highly liquid assets (as defined in article 416 of the CRR) while being able to remain open-ended in accordance with EU/694/2014;
b.) to require LOFs that exceed the aforementioned alternative threshold of 85% to be considered closed-end - unless the liquidity management as applied and the frequency for redemption opportunities chosen thereby clearly can assure open-end status.

An alternative solution could of course also be found in exempting specific funds, like the (Dutch) microfinance and green funds, from the scope of the proposed article 16 (2a). DUFAS would be open to discuss such an option in more detail if it were to be considered.

Regarding loan origination

The EC's proposal makes loan origination a regulated activity which will be permitted under the AIFMD and DUFAS welcomes this move in and by itself. However, in addition to the remarks as made regarding the 60%-threshold under the LMT-heading above, DUFAS would like to ask for attention for the following.

DUFAS and its members noted that there is no definition in the proposal for 'loan' nor 'loan origination'. We would therefore like to stress that this will leave room for interpretation regarding a.o. the applicability of the requirements regarding loan originating funds. In order to prevent any uncertainty from arising on the actual activities involved, we would like to suggest to the EC to reconsider their choice to leave out such definitions.

We would also like to draw attention to the fact that the 20%-limit for lending to a single borrower who is a financial or collective investment undertaking introduced in article 15(4a) of the proposal doesn't appear to reflect the current economic reality. In order to prevent misunderstanding of this specific stipulation we would like to ask for further clarification regarding the level at which it should be assessed: lender of record or ultimate borrower? If we understand correctly (see rationale in (10)), the provision regarding the single borrower is for risk-diversifying purposes, and should be addressed as such, meaning that a look-through to the ultimate borrower is required or permitted if that is fitting for risk purposes. We would therefore like to suggest that further clarification be included that this limit is to be calculated with regard to the ultimate underlying borrower. According to DUFAS this would recognize the fact that f.i. in the case of micro-financing, whereby a

platform lender serving as intermediary to provide loan financing to a multitude of smaller borrowers, the platform lender is not seen as a single borrower.

Furthermore, DUFAS would like to ask for a further clarification of the provisions in article 15(4b) regarding the application date of the 20%-limit as these are insufficiently clear on what is to be arranged in the prospectus or the constitutional documents, and moreover on when this has to be arranged. We would also like to note that the rationale behind these stipulations is missing, where it would be helpful for interpretation purposes.

DUFAS and its members also like to ask for a further clarification regarding the proposed risk retention, more specifically whether it will apply per loan and what this implies for loans which can only be transferred in their entirety? We worry that the current proposal might lead to practical impossibilities.

Regarding delegation

DUFAS appreciates the proposal's recognition that AIFMs may delegate more portfolio management or risk management functions than they retain. We also welcome the clarifications in the current proposal regarding the scope of the delegation regime.

However, we would like to suggest the consideration of an amendment to the recitals to specify that the delegation rules should only apply to tasks for which the AIFM bears direct responsibility. According to DUFAS, the scope of the delegation regime should not, by default, include all actors involved in the AIFM's value chain. It should ideally be limited to those tasks for which the management company is legally responsible (i.e. the investment management functions).

There is no maximum proportion of activities to be delegated in the proposal, however, delegation to third country entities will be subject to increased reporting and therefore, probably, additional supervisory scrutiny. NCAs will be required to send annual notifications of delegation arrangements when more risk management or portfolio management is delegated to a third country entity than is retained. ESMA will be required to publish regulatory standards regarding the content of these notifications. These standards could then also apply to already existing delegation arrangements.

DUFAS worries that these stipulations will add to the already impressive reporting burden and we would like to therefore ask for fact finding by the NCAs using the regular information as obtained from the AIFM in the field of delegation. The content of what there is to be reported might imply that competent authorities will eventually interfere with regular management activities whereas these activities in themselves do not create substantial risks.

Furthermore, we would like to ask whether excluding intra-group delegation from the scope of the proposal could be considered, given the specific nature of these arrangements and the stakeholders involved. DUFAS thinks a comparison could be made with delegating activities within a single legal entity, which are exempt from these stipulations.

Regarding (supervisory) reporting

DUFAS welcomes an initiative to collect supervisory data in a way that avoids duplication and reduces inconsistencies between reporting frameworks. Such an initiative should, however, in DUFAS' opinion, bring about first and foremost a better coordination between relevant authorities in order to prevent the same data from being requested by different supervisors.

DUFAS would also like to draw attention to the fact that certain provisions and terms on (supervisory) reporting are reframed in the proposal in a way that implies broader reporting requirements, e.g. 'principal markets' become 'markets', 'main instruments' become 'instruments'

and 'principal exposures' becomes 'exposures'. According to DUFAS and its members this makes for a frame in which reporting requirements will be extended even further. We consider this to be worrisome because of the already impressive reporting burden and the fact that extending the requirements might also lead to overshooting. As the data to be reported will be less concretely framed, the proper interpretation of the data by the authorities will also become more difficult and time-consuming.

In addition, DUFAS notices that there are provisions scattered throughout the proposal about improving or expanding reports (on LMTs and on delegation, see above) that will also contribute to the expansion of the reporting requirements.

Regarding disclosure to investors

The proposal establishes that the AIFM must disclose additional information towards its investors with regard to the conditions under which the selected LMTs will be used and with regard to the related (direct or indirect) fees borne either by the AIFM (or its affiliates) or by the AIF.

Given the already existing disclosure requirements for AIFs, also resulting from both the PRIIPs regulation and MiFID, DUFAS is of the opinion that current disclosure should be regarded as sufficient and thus allowing for investors to make an informed investment decision. An additional, new set of disclosure rules might create confusion and with regard to charges and fees this might even end with inconsistency in relation to PRIIPs and MiFID provisions on this topic.

Furthermore, we would like to emphasize that the proposed frequency for reporting - on a quarterly basis, as written down in article 23 (1a) - is of little or no additional value to investors as the calculation of the fees would then have to be based on estimates. Thus, DUFAS would like to ask for this particular stipulation to be removed.

Regarding transitional provisions/grandfathering

DUFAS notes that, given the practical consequences of level 1 changes, grandfathering provisions are needed throughout the proposal to enable AIFMs to transition to the new rules while protecting the legal expectations of investors who subscribed to the fund prior to the coming into force of the new amendments.

We also note that the subsequent enactment of delegated acts will impact the operation of a number of the provisions. To ensure a consistent and uniform application of the rules, we would like to suggest that it be specified that those provisions only come into effect after the publication of the final level 2 and 3 texts in order to allow for sufficient time to review and align practices with the technical clarifications.

DUFAS: Dutch Fund and Asset Management Association

Since 2003, DUFAS has been committed to a healthy asset management sector in the Netherlands. DUFAS has more than 50 members: from large asset managers who invest Dutch pension and insurance assets to smaller, specialist asset managers. DUFAS increases awareness of the social relevance of investing, helps to develop sector standards and represents the sector in the implementation of new laws and regulations. In addition, DUFAS is committed to a single European market with equal regulations.

More information

Would you like to respond, or should you have any questions? I would be pleased to hear from you. Please feel welcome to e-mail Randy Pattiselanno, DUFAS manager strategy & regulatory affairs, at rp@dufas.nl.