U.S. CHAMBER OF COMMERCE

Comments on the European Commission's Public Consultation on the Review of the Alternative Investment Fund Managers Directive (AIFMD)

January 2021

The U.S. Chamber of Commerce ("the Chamber") welcomes the opportunity to respond to the European Commission's ("Commission") *"Public Consultation on the Review of the Alternative Investment Fund Managers Directive (AIFMD) ("Consultation")."*

The Chamber is a longtime advocate for strong commercial ties between the United States and the European Union. According to a recent Chamber study, the U.S. and EU are jointly responsible for more than one-third of global gross domestic product, and transatlantic trade and investment supports more than 16 million jobs on both sides of the Atlantic.[1] In the U.S. and globally, we advance balanced policy frameworks that support economic growth, promote consumer protection, and foster innovation. The Chamber is also a leading business voice through its Center for Capital Markets Competitiveness in advancing policies for efficient capital markets in a global economy.

Introduction

The Chamber's members, many of whom are heavily invested in Europe and maintain global operations, represent a key stakeholder base as the Commission reviews the Alternative Investment Fund Managers Directive ("AIFMD"). The Commission correctly recognizes the importance of the AIFMD in establishing a market for Alternative Investment Funds ("AIFs").

As the Commission highlights in its report to the European Parliament and the Council on 10 June 2020, the AIFMD has not only enhanced investor protections, but is responsible for "facilitating the improved monitoring of risks to the financial system and the cross-border raising of capital for investments in alternative assets."[2]

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[1] U.S. Chamber of Commerce & AmChamEU, The Transatlantic Economy 2020.

[2] European Commission, Report from the Commission to the European Parliament and the Council assessing the application the scope of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers.

Moreover, in a letter to the Commission dated 18 August 2020, the European Securities and Markets Authority ("ESMA") notes that "the AIFMD has provided a solid framework for alternative investment funds in Europe. It gave a basis for consistent supervision of alternative managers in the EU, thus reassuring investors in Europe and the world that alternative investment funds are grounded in a credible regulatory framework."[3]

Together with the Undertakings for Collective Investment in Transferable Securities Directive ("UCITS"), the AIFMD is considered a regulatory success story in expanding European capital markets since it was implemented in July 2013. The Chamber, while recognizing regulators and supervisors' arguments about improving and updating specific areas of the AIFMD framework, cautions the Commission against taking actions that would unnecessarily disrupt this effective model of capital formation and disadvantage the investors of AIFs.

While regulatory considerations around post-Brexit environments are important, the Chamber is specifically concerned about any intention to unduly modify the rules surrounding the use of delegation and substance requirements by asset managers. Changes to the existing model would have a direct and significant impact on the European fund industry and in other third countries where non-EU managers are delegates for EU management companies.

Benefits of Delegation

Delegation is a common practice that allows Alternative Investment Fund Managers ("AIFMs") to delegate a variety of fund management functions to third parties, including third parties outside the EU. Such functions include portfolio management, risk management, accounting and valuation, marketing, and administrative activities. Delegation is one of the key pillars of the EU's cross-border investment model.

Delegation provides important benefits that extend directly to investors.

- ***Access to the most qualified talent:*** AIFs may require specialized skills in the asset management space that are not available in the location where the AIF is domiciled. In a report on delegation, the International Organization of Securities Commissions (IOSCO) aptly explained that "the increasing sophistication of financial markets as well as the need to follow investment strategies on an international basis often require specialised know-how that a

[3] ESMA, Letter on the review of the alternative funds managers directive, August 2020.

management company may lack on a stand-alone basis."[4] Investors thereby benefit when AIFMs can leverage the expertise in specialized markets in order to optimize the AIF's assets.

- ***Economies of scale that reduce costs:*** By pooling functions, particularly in accounting, marketing, and administrative activities, AIFMs are able to reduce the cost of managing AIFs. Such cost-savings are passed on to investors.

- ***Increased investor protections:*** By delegating responsibilities, AIFs and their investors also benefit from an asset management team's internal risk management expertise. U.S. asset managers in particular already operate in a highly regulated financial services environment that values investor protections.

Addressing the Consultation

It is clear from questions 50-55 of the Consultation that the Commission could be considering potential changes to the AIFMD's rules on delegation. The questions address whether the AIFMD rules on delegation:

- Are effective in preventing the creation of letter-box entities in the EU.
- Ensure effective risk management.
- Should be complemented by additional measures such as quantitative delegation criteria, a list of core or critical functions that must always be retained by the AIFM, or any other requirements.
- Whether the AIFMD standards should apply regardless of the location of a third party, to which AIFM has delegated the collective portfolio management functions, in order to ensure investor protection and to prevent regulatory arbitrage.
- Are consistently enforced throughout the EU.
- Should be extended so as to apply to UCITS.

The Chamber believes that AIFs are already highly and effectively regulated, and that investors are also well-protected. The Chamber does not support changes to the current delegation rules that create new limits to the use of delegation by AIFs, such as requiring additional quantitative criteria or requirements to be met before third-party delegation is allowed.

[4] IOSCO, Delegation of Functions, December 2000.

The Commission seems particularly concerned about preventing letter-box entities and ensuring effective risk management. The Chamber believes that current delegation rules already are effective in preventing letter-box entities and in minimizing risk. Moreover, the AIFMD has effectively balanced providing asset managers with access to European markets while ensuring the protection of investors. Also, ESMA addressed the issue in 2017 through an opinion advising national authorities to reject any relocation request creating letter-box entities where, for instance, extensive use of outsourcing and delegation is foreseen with the intention of benefitting from an EU passport, while essentially performing all substantial activities or functions outside the EU27.[5]

Evidence demonstrates the effectiveness of the AIFMD, particularly in preventing letter-box entities and in appropriately managing risks. In its June 2020 report, the Commission references an evidence-based study of the AIFMD conducted at its request by KPMG. The study describes the clear rules surrounding the use of delegation by AIFMs, particularly in the areas of letter-box entities and risk management[6]:

- **Article 20(1)(a)-(f):** Allows for delegation of portfolio management *or* risk management functions, but disallows the delegation of both.

- **Article 20(2)(a):** Prohibitive limits are set on portfolio management and risk management, such that these functions may not be delegated to "the depositary, a delegate of the depositary or any other entity whose interest may conflict with those of the AIFM or the investors of the AIF."

- **Article 20(3):** The AIFMD may not become a letter-box entity. Article 82 of the Commission Delegated Regulation supplementing the AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision provides a series of qualitative criteria against which a third-party could be deemed to be a letter-box entity.[7] We take the view that these criteria are exhaustive and ensure both investor protection and a management company's ability to serve its investors.

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[5] ESMA, Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, July 2017.
[6] European Commission, Report on the Operation of the Alternative Investment Fund Managers Directive (KPMG Report), December 2018, (pp. 176-177).
[7] European Commission, Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

Importantly, current AIFMD rules further protect investors and minimize risks by providing national regulators with jurisdiction over delegated activities by AIFMs. As the KPMG study explains, AIFMD Article 20(1) requires an AIFM to notify and justify delegation to a National Competent Authority ("NCA") prior to implementing delegated activities. Each NCA is well-positioned to understand the intricacies of its specific financial markets and thus take responsibility for determining if delegated activities would result in a letter-box entity. The role of national regulators is thus a critical component of delegation and should not be undermined.

Moreover, AIFMD rules minimize risks through additional safeguards such as requiring delegates to maintain sufficient resources to perform the delegated functions and requiring the AIFM to maintain responsibility for all such delegated tasks.[8] This raises questions on the need for a list of core or critical functions that would be always performed internally and may not be delegated to third parties.

Regarding regulatory arbitrage and the consultation question on whether AIFMD standards should apply regardless of the location of a third party, to which an AIFM has delegated the collective portfolio management functions, we would note that U.S. asset managers are in many cases delegates of EU AIFMs and UCITS management companies. It would thus be difficult for U.S. asset managers to comply in full with the regulatory standards set out in the AIFMD framework, and the potential extraterritorial reach of this proposal should be carefully assessed.

KPMG's report to the Commission clearly demonstrates that delegation under the current AIFMD guidelines both benefits and protects investors. The following specific examples recognize that the AIFMD has effectively minimized areas of risk and provided benefits through economies of scale and expertise:

- "Survey results would 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."[9]
- Delegation "allows AIFMs to adopt the most economic business models and to access the best expertise to the benefit of AIF investors."[10]
- "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."[11]

[8] KPMG Report, p. 177.
[9] KPMG Report, p. 178.
[10] KPMG Report, p. 179.
[11] KPMG Report, p. 180.

- "The evidence indicates that the AIFMD delegation provisions have imposed effective controls on the activity of delegating AIFM functions, thereby limiting and managing key operational risk for AIFs and AIF investors, and have done so in an efficient manner.[12]

Investors benefit from international capital markets, including access to the expertise of asset managers from outside the EU. The Chamber believes that any changes to the current guidelines around delegation that result in limits on delegated activity would greatly disadvantage investors and harm competition in several ways.

First, limits to delegated activity would undermine economies of scale, resulting in increased costs to investors.

Second, limits to delegation would reduce access to and utilization of expert know-how by the AIF. As a result, we would expect less effective management of the AIF, potentially leading to decreased economic returns for investors.

Third, limits to delegation may weaken AIF competition by discouraging non-EU asset managers from entering the European market. Fewer participants supporting AIFs in Europe would result in reduced investor choice in high-quality AIFs.

Fourth, potential restriction on the use of seconded staff could lead to operational difficulties.

Conclusion

The Chamber believes the current AIFMD rules on delegation are effective in managing risks and protecting investors, while simultaneously providing investment opportunities in AIFs that are helping to grow the EU capital markets. We thank the Commission for the opportunity to provide these comments and look forward to continued dialogue as the EU reviews the AIFMD.

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[12] KPMG Report, p. 180.