

# Memorandum

## Developments in the AIFMD Review—ESMA Recommendations

September 30, 2020

Article 69 of the AIFMD<sup>1</sup> requires the European Commission (the “Commission”) to review the application and scope of the Directive. In January 2019, the Commission published a report containing the results of a study prepared by KPMG that was carried out to provide evidence for the Commission’s article 69 review.<sup>2</sup> This assessment was followed by a further report published by the Commission on 10 June 2020,<sup>3</sup> which provides a general survey of the functioning of the AIFMD in certain areas. Following the submission of its June 2020 report to the European Parliament and the Council, article 69 of the Directive further obliges the Commission to put forward proposals, including proposals for amendments to the AIFMD, if deemed appropriate. In its June 2020 report, the Commission noted that it “is still assessing the need for further proposals in this domain.”

In response to the Commission’s ongoing assessment of the AIFMD, the European Securities and Market Authority (“ESMA”) published a letter on 18 August 2020 to the Commission (the “ESMA Letter”) highlighting areas where “improvements could be made” to the Directive.<sup>4</sup> As the financial markets regulator for the European Union (the “EU”), the suggestions put forth by ESMA are expected to have significant influence with the Commission. While it is too early to predict whether, and to what extent, the Commission will adopt such recommendations, and if so, in what form, the proposals are noteworthy as they suggest that ESMA views material shortcomings in the AIFMD that ought to be addressed. To the extent that these “improvements” are accepted by the Commission as such, it may also make it more likely that the identified deficiencies will be mitigated through amendment proposals to the Directive. Given the impact of the AIFMD on the alternatives industry—both inside and outside of Europe—sponsors of alternative investment funds should be cognizant of these proposals and remain abreast of developments as they progress through the AIFMD review process. For sponsors of private funds, particularly those outside of the EU, key aspects of the ESMA Letter follow.

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<sup>1</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the “AIFMD” or the “Directive”).

<sup>2</sup> The Report on the Operation of the Alternative Investment Fund Managers Directive is available at: [https://ec.europa.eu/info/sites/info/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/190110-aifmd-operation-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-aifmd-operation-report_en.pdf).

<sup>3</sup> The Report from the Commission to the European Parliament and the Council Assessing the Application and Scope of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers is available at: <https://eur-lex.europa.eu/legal-content/EN/TEXT/PDF/?uri=CELEX:52020DC0232&from=EN>.

<sup>4</sup> The ESMA letter is available at: [https://www.esma.europa.eu/sites/default/files/library/esma34-32-551\\_esma\\_letter\\_on\\_aifmd\\_review.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf).

## Delegation of Portfolio Management

ESMA has previously expressed concern regarding the extent of delegation arrangements,<sup>5</sup> and the position in the ESMA Letter is generally consistent with prior positions in this regard. While ESMA acknowledges that “delegation arrangements may increase efficiencies and ensure access to external expertise,” it notes that “portfolio management functions are often largely or even entirely delegated” and that “a large amount of . . . management fees . . . are paid to delegates.” Given the scope of delegation and flow of revenues—often to entities outside of the EU—ESMA believes such arrangements may “increase operational and supervisory risks.” With the impending finalization of Brexit and the potential for regulatory arbitrage, ESMA expects the “delegation of portfolio management functions to non-EU entities . . . to increase.” As a result, the ESMA Letter proposes “further legal clarifications on the maximum extent of delegation” and “legislative amendments . . . [to] ensure that the management of [alternative investment funds (“AIFs”)] . . . is subject to the regulatory standards set out in the AIFMD . . . , irrespective of the regulatory license or location of the delegate.” Since that the vast majority of non-European sponsors with affiliated European alternative investment fund managers (“AIFMs”) delegate portfolio management outside of the EU, this may be a significant area of development.

## Hosted AIFM Solutions

Akin to ESMA’s concern regarding the delegation of portfolio management, the ESMA Letter also lobbies for additional requirements on hosted AIFM solutions provided by third parties. Under the hosted AIFM model, a third-party fund manager provides a turn-key management platform for fund sponsors and typically delegates portfolio management back to such sponsor. While ESMA has previously expressed concern regarding certain aspects of the hosted AIFM solution, the ESMA Letter makes clear that the regulator believes there is an intrinsic conflict embedded in the model. Specifically, ESMA notes that under the hosted arrangement, the fund sponsor “is also the client of the . . . [hosted] AIFM . . . and may therefore decide to replace the . . . [hosted] AIFM with another . . . service provider . . . .” As a result, the hosted AIFM faces “significant conflicts of interest since controlling and challenging the [the sponsor] in the best interest of investors may come at the risk of losing a client/business partner . . . .” Given the pervasive use of hosted AIFMs by non-EU sponsors seeking to obtain the AIFMD marketing passport, changes in this area may have material implications for sponsors outside of the EU.

## Loan Origination

As a supplement to its 2016 opinion on the subject,<sup>6</sup> the ESMA Letter reiterates the position that “there should be a specific framework for loan origination within the AIFMD.” While certain EU Member States have adopted conditions on loan origination by AIFs, ESMA has been consistent in its view that a common framework for loan origination by AIFs is necessary to “promote a capital markets union” and to “reduce regulatory arbitrage.” Although the ESMA Letter primarily cross-references points in the 2016 opinion, it specifically highlights its prior

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<sup>5</sup> See [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](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)

<sup>6</sup> [https://www.esma.europa.eu/sites/default/files/library/2016-596\\_opinion\\_on\\_loan\\_origination.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-596_opinion_on_loan_origination.pdf)

recommendation that “that loan funds can only be closed-ended and can only be marketed to professional and semi-professional investors.” Given the growth of debt originating funds following the most recent financial crisis, material constraints on the ability of AIFs to engage in direct lending may have broader implications for the market, including more limited access to capital.

### Definition of AIF

Since the implementation of the AIFMD, the definition of the term “AIF” and the varying Member State interpretations thereof has led to significant uncertainty for fund sponsors. The ESMA Letter highlights its agreement that “the current definition[] [is] too vague and not specific enough and thus need[s] to be specified more clearly . . . .” Accordingly, ESMA proposes amending the Directive to incorporate definitions for related terms such as “pooled return” and “investment policy” as well as “specifying the distinction between holdings and private equity funds and clarifying the definition of a joint venture.” Since the applicability of the AIFMD to a given product hinges on the definition of the term “AIF,” any movement in this regard may significantly expand or narrow the reach of the Directive.

### Reverse Solicitation

While reverse solicitation is not expressly referenced in the AIFMD—and is therefore not subject to the Commission’s article 69 review—the ESMA Letter notes “the importance of clarifying the notion . . . , which is currently subject to divergent practice and implementation at [the] national level . . . .” Anecdotal evidence suggests that reliance on reverse solicitation is waning, but it has certainly not become an anomaly in the market. For some non-European sponsors, reverse solicitation remains the primary means to access European capital. Accordingly, efforts to curtail the availability of reverse solicitation may benefit larger sponsors—especially those with the capability to distribute AIFs via the AIFMD marketing passport.

### ESG Reporting

As part of proposed changes to the AIFMD reporting regime, ESMA notes that the Commission’s review is “a very good opportunity to add ESG factors . . . [to AIFMD] reporting.” More specifically, ESMA proposes an amendment to the Directive “that ESG factors should be considered in the AIFMD reporting in order to monitor ESG related risks.” Given the evolving standards of reporting in the ESG space, the ESMA Letter recommends that technical standards regarding such reporting follow at a later date. In conjunction with the EU’s Regulation on sustainability-related disclosures in the financial services sector,<sup>7</sup> which requires certain ESG-related disclosures beginning in the first quarter of 2021, sponsors should be mindful that ESG disclosure and reporting obligations are expanding in Europe and should plan accordingly.

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<sup>7</sup> 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.

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