What is the AIFMD[1]?

In the aftermath of the 2008 financial crisis, EU policy makers identified several gaps within European and national regulatory and supervisory frameworks for the financial services industry.

One of these concerned the activities of managers of Alternative Investment Funds (AIFs), which are all funds not harmonised under the UCITS[2] Directive. They include hedge funds, private equity funds, real estate funds and a wide range of other types of institutional funds. These types of funds are targeted at professional and institutional investors, while UCITS are targeted at retail investors.

Investment funds play a crucial role in facilitating the accumulation of personal savings, whether for major investments or for retirement. They are also important because they make institutional and personal savings available as loans to companies and projects which contribute to growth and jobs.

The 2009 European Commission Impact Assessment noted the important role that Alternative Investment Fund Managers (AIFMs) play in financial markets. The report stated that AIFMs were not the cause of the crisis but that the crisis did place stress on the sector, as it did on the wider economy.

To further enhance investor protection and financial stability, EU policy makers agreed a new law: the AIFMD – Alternative Investment Fund Managers Directive – which entered into force in July 2011 and was fully implemented by July 2013 (transposition deadline).

Fundamental Legislative Change Is Not Required

AIFMD includes a clause that requires the Commission to conduct a review of the legislation and, if necessary, to submit a proposal to the European Parliament and the Council with amendments to the Directive.

DG FISMA commissioned KPMG to conduct a comprehensive evidence-based review of how the Directive has worked in practice since its application in 2013. This work was led by KPMG Germany and the report was published on 10 January 2019.

The KPMG report concludes that the AIFMD has successfully achieved its objectives and has played a major role in creating a harmonized and stringent regulatory framework for AIFMs. The report identifies some areas requiring further analysis, including diverging interpretations of rules by NCAs and overlapping reporting requirements with other EU legislative requirements.

In our February 2021 response to the European Commission's AIFMD consultation we called for greater supervisory convergence as an important factor in the further development of the EU's single market for investment funds.

Given the conclusions of the KPMG report and the absence of any fundamental issues with the legislative framework, we believe there is no need for a substantial overhaul of the AIFMD and that the principal objective should be to maintain stability in relation to the AIFMD framework.

Any Legislative Change Should Support CMU and COVID Recovery Objectives

Any new legislation should be necessary, proportionate, and appropriately support the achievement of the Capital Markets Union (CMU) and post-COVID recovery objectives. These changes should encourage greater investments in the economy and allow for a rapid re-capitalisation of companies.

The funding situation in Europe contrasts with the US where the bulk of financial intermediation takes place via capital markets and where private equity funding and loan funding is well developed. Investment funds are an effective and regulated mechanism to channel investor capital to a range of investment opportunities and could act to increase funding for Europe's SMEs.

1 Directive 2011/61/EU – 8 June 2011

2 Directive 2009/65/EC – 13 July 2009 – the UCITS Directive is the main European framework covering collective investment schemes. This category of investment funds accounts for around 75% of all collective investments by small investors in Europe.

What is Delegation and Why Do Firms Delegate?

We are aware that the topic of delegation has been raised on several occasions and believe that it is important to clarify how it works in practice, why it is used and how the current regulatory framework effectively protects investors and maintains financial stability.

When managing an investment fund, the main tasks a fund management company (ManCo) carries out are:

- investment management (deciding which investments to buy and sell)
- fund administration (keeping the accounts, processing subscriptions into and redemptions out of the fund and valuing the fund's assets)
- distribution (marketing the fund to potential new investors)

The ManCo may decide to delegate the performance of some of these tasks to another firm. That other firm might be part of the ManCo's wider group or it might be an unrelated third party. The underlying reason why a ManCo will delegate is almost always the same – it is more efficient to delegate a specific task to another firm (that can achieve economies of scale) than to perform it in-house.

Additionally, the decision to delegate can be driven by the ability to provide the investor with specialist expertise. For example:

- Fund administration is a specialised activity requiring detailed processes and knowledgeable staff to ensure that accounts are kept properly, subscriptions and redemptions are processed promptly, and valuations are calculated accurately. Almost all Irish ManCos delegate administration to a specialist fund administrator, typically based in Ireland.[3]
- Delegating investment management allows ManCos to access investment professionals who are experts in particular assets, markets, investment strategies, etc.

How Investors Benefit From Delegation

Delegation ensures that investors are provided with access to the best expertise available. It is particularly important in allowing the AIFM to benefit from efficiencies within a group structure that will provide both cost savings and better investor outcomes.

The fund can be established and administered in Ireland which brings benefits in terms of a strong regulatory environment, world class fund administration expertise and tax efficiencies[4].

Investment management for the fund can be delegated to best-in-class investment professionals, wheresoever they are located, who will bring expertise on particular asset classes or geographical locations (e.g. Japanese equities, Brazilian bonds or Australian infrastructure) and provide access to global trading capabilities. This allows fund providers to build funds that can best serve investors' needs and provides EU investors with access to global markets.

What Restrictions Does AIFMD Put on Delegation?

The AIFMD recognises the benefits of delegation and specifically provides that it is permissible for ManCos to delegate the performance of tasks. The European Commission and ESMA continue to acknowledge the benefits of delegation in terms of enhancing efficiency and scale, as well as granting access to more specialised investment expertise, which results in better outcomes for investors.

At the same time, the AIFMD limits the extent to which ManCos can delegate. Regulators want to ensure that they can effectively supervise ManCos notwithstanding any delegation arrangements in place. In particular, regulators want to ensure that ManCos are entities of substance and that they have not delegated away the performance of so many of their tasks that they are effectively 'letter-box entities'.

Taking Ireland as an example, the Central Bank of Ireland (Central Bank) expects each ManCo to have at least 3 full-time employees, or equivalent, and it expects key management staff to be located in Ireland. This is a minimum number – expectations around the minimum number of staff will increase as the size and complexity of a ManCo increases. These requirements ensure the maintenance of sound governance and control mechanisms in the Irish entity, including rigorous due diligence and delegation monitoring processes.

These processes are essential as the AIFMD makes it clear that a ManCo's liability towards the fund and its investors shall not be affected by the fact that the ManCo has delegated functions to a third party. Simply put, delegation does not allow the circumvention of responsibilities, obligations, or liability.

[3] Ireland is recognised as one of the leading global centres of excellence for fund administration and has over 50 authorised fund administration firms.

[4] Irish domiciled funds are exempt from corporation tax at the fund level and the income is therefore taxed at the level of the investor rather than the fund. Irish regulated funds are exempt from Irish tax on income and gains derived from their investments and are not subject to any Irish tax on their net asset value. There are additionally no net asset, transfer or capital taxes on the issue, transfer or redemption of units owned by non-Irish resident investors. Other than in respect of certain funds which hold interests in Irish real estate (or particular types of Irish real estate related assets), non-Irish investors are not subject to Irish tax on their investment and do not incur any withholding taxes on payments from the fund. Essentially, what this means is that the investor pays tax on their investment income in the country they are resident in when they receive it.

Where Do Firms Delegate To?

When managing a fund, ManCos are responsible for 3 key functions – fund administration, investment management and distribution. Irish ManCos typically delegate fund administration to a specialist service provider, typically located in Ireland. Investment management and distribution are typically delegated to the firm that is the driving force behind the establishment of the fund, known as the promoter[5].

A global operating model, utilising inter-group companies and external providers, allows firms to (i) deliver the 24/7 servicing that clients and their investors demand, (ii) establish and continue to develop deep centres of operational expertise and specialist function (e.g. technology), and (iii) support investors with services in the appropriate language. In many cases, the use of centralised functions or Centres of Excellence ("CoE") will reduce instances of 'unique' processes being developed in single locations. Furthermore, the use of centralised locations and CoEs can allow for stronger resiliency across locations and greater breadth of operating model.

The local (Irish) legal entities have established governance and oversight frameworks which oversee the quality and consistency of service received from their CoEs. They ensure the CoE has the appropriate knowledge of the regulatory obligations of the local (Irish) jurisdiction and ensures engagement by the CoE as required (and as defined in inter-group Service Level Agreements) to meet those regulatory obligations.

This approach avoids the need to establish and maintain multiple replica teams at local legal entity level which may not have the comparable depth of expertise necessary to manage the risks appropriately. It should also be recognised that local legal entities can benefit from the scale and buying power of the group.

Third Country Delegation Framework Under AIFMD

One of the key investor protection measures contained in the AIFMD delegation rules is a requirement that investment management is only delegated to investment managers that are authorised or registered for the purpose of asset management and subject to supervision.

Investment managers located in the EU and authorised under MiFID satisfy this requirement and are eligible for appointment. Investment managers located in third countries (i.e. outside the EU) need to demonstrate to the Central Bank that (i) they are authorised in their home country and (ii) the regulatory regime for investment firms in their country is effectively equivalent to the regime that applies in the EU regime.

In addition, there needs to be a memorandum of understanding in place between the Central Bank and the supervisory authority in the investment manager's home country. This written agreement typically gives the EU regulator access to documentation, information, and the ability to request to carry out on-site inspections of the delegate.

Practical Example – Application of Framework in Ireland

A typical example is as follows: A US investment manager has expertise in a particular sector (e.g., green energy) and has enjoyed success with investors in the US. It wishes to expand into the EU and to offer its services to EU investors. To do this, it decides to establish a fund in Ireland.

The fund is required to appoint an Irish based depositary to safekeep the fund's assets, oversee the ManCo and monitor cashflows. The fund also needs to appoint a ManCo, and the US investment manager decides to set up its own Irish authorised ManCo for this purpose. The ManCo delegates fund administration to an Irish based specialist fund administration firm. It delegates investment management and distribution to the US investment manager. The ManCo hires 3 full time employees in Ireland to run the ManCo and to closely oversee the delegates on a day-to-day basis. The key managerial functions these employees will oversee are investment management, fund risk management, operational risk management, regulatory compliance, distribution and capital and financial management.

[5] Promoters from 54 countries have established funds in Ireland with most located in the UK (40%) and North America (30%).

Final Comment

Since the implementation of the AIFMD in 2013, the Central Bank's approach to how Irish authorised ManCos are resourced and how they oversee their delegates has evolved. The Central Bank has articulated its expectations through its rulebooks and guidance, most notably its Fund Management Company Guidance (commonly known as 'CP86')[6]. Irish Funds has actively engaged with the Central Bank throughout this process to understand what the Central Bank is trying to achieve, to provide information on the likely impact of various proposed approaches and to provide feedback on what it believed was the best way forward.

This has resulted in a regulatory regime for Irish authorised ManCos that is rigorous and that places high expectations on ManCos and their staff in terms of protecting investors and safeguarding financial stability. It would be accurate to say that the regime in Ireland sets a strong benchmark for the rest of Europe to follow. Irish Funds supports this approach and is keen to ensure that Irish ManCos are well run and protect the interests of the investors they serve.

As such, we are strongly supportive of increased supervisory convergence at an EU-level to ensure that the AIFMD is applied in a consistent manner and that investors receive the highest standards of protection.

'Empowering Citizens and Enabling the Economy' is our new thought leadership paper that clearly establishes the important role that Ireland plays in the wider EU financial services ecosystem. In it we demonstrate how the investment funds and asset management industry can contribute to enabling economic growth, providing citizens with the tools to protect their financial future, and achieving a sustainable future.

6 https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds-service-providers/161219_final-fund-mancos-guidance-_cd-(002).pdf?sfvrsn=0

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