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Proposed Refinements to the Review of the Alternative Investment Fund Managers Directive (AIFMD) and the UCITS Directive

ICI Global[1] welcomes the targeted approach that the European Commission (Commission) has adopted in its review of the AIFMD and associated changes to the UCITS Directive,[2] but we strongly recommend some modifications to the proposed delegation and liquidity management tool frameworks.

ICI Global represents global regulated investment fund managers and the end-investors they serve, and our members manage approximately €5.4 trillion in UCITS.[3] Our proposed modifications seek to strengthen the Commission's proposal by aligning the new measures with current best practices. The AIFMD review is a cornerstone of the European Union's (EU's) efforts to advance the Capital Markets Union (CMU). A strong and successful framework for regulated investment funds provides everyday investors with the confidence to place their savings into the EU capital markets. This in turn drives investments that are channeled into the European economy to support key priorities, including climate sustainability and the digital sector.

As the Commission's proposed AIFMD review is currently being considered by the Council of the European Union and the European Parliament, we feel it is important to provide concrete suggestions—from the global funds industry's perspective—that would improve upon the Commission's proposed framework.

Our four key suggestions:

1. Any requirement for notifications by national competent authorities (NCAs) to the European Securities and Markets Authority (ESMA) regarding a management company's delegation arrangements should be based only on qualitative factors, and not on a quantitative trigger as currently implied by requiring notifications when "more" is delegated to third countries than retained. A backdoor quantitative trigger such as this would provide misleading and inconsistent information to ESMA.

2. To foster greater harmonization on supervision of delegation arrangements across Member States, NCAs and ESMA could reinstate a supervisory coordination network. This is a better tool than a notification requirement.

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[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of $41.6 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Brussels, Hong Kong, and Washington, DC.

[2] *See* Proposal for a Directive of the European Parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds (Proposal for a Directive), available at: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12648-Financial-services-review-of-EU-rules-on-alternative-investment-fund-managers_en.

[3] ICI Global member assets based on data from Morningstar Direct.

3. If policymakers need additional information on delegation arrangements, NCAs should share qualitative metrics, including those on substance and conduct we outline in Annex 1.

4. On liquidity provisions, we support the broad array of liquidity management tools (LMTs) proposed by the Commission, but we strongly recommend against providing public authorities the discretion to activate or deactivate an LMT. We also caution against mandating the selection of an LMT or set of LMTs.

Recommended Refinements – Delegation Framework

As policymakers in the EU consider changes to the AIFMD and the UCITS Directive, it is paramount that they preserve the EU's globally successful UCITS framework that allows UCITS to access investment expertise around the world in a cost-effective manner and to take advantage of economies of scale and other efficiencies, with the benefits passed on to citizens using these funds to invest their savings. UCITS are already subject to robust supervisory evaluation of substance, oversight, and control of delegation arrangements by their respective NCAs. We are greatly concerned that, despite being portrayed as clarifications, the Commission's proposed revisions to the delegation framework could nonetheless reduce the attractiveness of the UCITS product.

We agree that investors benefit from robust supervisory evaluation of substance, oversight and control of delegation arrangements established by EU management companies. Where there are weaknesses, NCAs should require management companies to address and correct those weaknesses. We would note that during the more than three decades that the delegation framework has existed, we are not aware of any systemic risk having emerged as a result of delegation—a testament to the strong supervisory framework that already exists.

The current framework empowers—and indeed requires—NCAs to obtain the information they need to successfully oversee delegation arrangements. The AIFMD Delegated Regulation already contains clear and robust criteria for NCAs to assess substance, oversight and control, and these criteria are already applied to UCITS management companies by NCAs in practice. ICI Global supports the transposition of the following articles from the AIFMD Delegated Regulation into the UCITS Directive:

(i) Article 60, which describes the oversight and control functions that must be retained within the management company;
(ii) Article 75, which describes the process by which those oversight and control functions apply to ensure liability and responsibility cannot be delegated from the management company; and
(iii) Article 82, which describes the qualitative criteria for assessing when there is inadequate substance to maintain oversight and control within the management company.

The transposition of the relevant portions of these three articles will provide NCAs with the proper legislative and regulatory framework to assess compliance at the time a management company seeks authorization and on an ongoing basis. Collectively, these requirements ensure that (i) management companies are not letter-box entities and (ii) there is meaningful dialogue between the NCA and the management company regarding all of the firm's activities, whether these are delegated or retained.

Further, ICI Global supports the Commission's proposal to require UCITS management companies applying for authorization to provide more detailed information about the persons conducting the work of the

management company, the management company's technical resources, and the resources used to monitor and control delegates (proposed UCITS Article 7(1)(c,e)). ICI Global strongly believes that, together, the transposition into the UCITS Directive of the AIFMD requirements and requirement to provide detailed information at the time of authorization are a major step forward, and that further changes beyond that are not only unnecessary, but also risk harming the quality of the UCITS product and in turn impeding the development of the CMU for the benefit of everyday investors.

A. Delegation Reporting—NCAs Already Collect the Necessary Data

The proposed collection of additional information by ESMA regarding delegation arrangements, potentially on a frequent, periodic basis, is unnecessary and would pose an additional regulatory and compliance burden for firms and NCAs without any clear benefit. The qualitative criteria that NCAs collect allows NCAs to appropriately assess the substance of the oversight and control functions being retained, and to ensure that the individuals performing these functions have adequate competence and expertise.

We recognize the desire of some EU policymakers to improve supervisory information sharing at the EU level. We believe this is achievable using the qualitative information that NCAs already collect in practice for UCITS management companies, and will be required to collect after the transposition of the requirements into the UCITS Directive. The data that is collected includes information on oversight and control, liability and responsibility frameworks, satisfaction of substance requirements, and rationale for the delegation.

ICI Global believes the tools that NCAs and ESMA together have are sufficient and appropriate and could be used more systematically to meet the desire of some policymakers for increased supervisory information sharing and convergence of practices, if needed. For example, ESMA could re-establish the Supervisory Coordination Network (SCN) it used several years ago, as a platform to share information among NCAs regarding delegation practices.

The key message is: instead of requiring management companies to report new data fields, the industry strongly believes that NCAs already gather the information they need, have access to additional information if needed, and can use an SCN platform to share that information as needed with ESMA. In light of these existing tools, why prescribe additional, burdensome reporting?

B. Additional Reporting – If Needed – Should Be Qualitative

If EU policymakers nevertheless determine that additional information should be collected by NCAs and provided to ESMA, any such information should be qualitative in nature and not quantitative. A quantitative tick-the-box approach would not appropriately take into account the variety of ways in which firms structure their operations and delegation arrangements, and, in many instances, would not provide an accurate assessment of whether a firm should be considered a letter-box entity. An approach that focuses on the qualitative criteria and information collected by NCAs would better achieve the Commission's goal of ensuring a uniform level of investor protection across the EU. Some examples of qualitative supplementary information that could be considered are included in Annex 1.

C. The EU Should Not Implement a Quantitative Trigger for Notification Requirements

The current proposal requiring notification to ESMA where "more risk or portfolio management is delegated to third countries than is retained" would, effectively, introduce a quantitative metric by the back door. The mechanism of delegation, which is used for both portfolio management and risk management, is not clearly quantifiable. In some cases, a large share of portfolio management will be delegated to a manager in Paris,

Hong Kong, London or New York, for example, but all of the risk management will be retained in the jurisdiction where the fund is domiciled. We do not see this illustrative set-up as necessitating the triggering of a notification. Cut and dry classification of the percentage of an activity that is delegated does not provide meaningful information and should not be used as a threshold test for triggering a notification.

Recent suggestions in the Council that would require an NCA to report to ESMA with information on delegation based on a specified list of tasks or the basis of an AUM figure do not reflect how delegation arrangements are set up in practice and would lead to misleading and arbitrary outcomes that do not reflect the current AIFMD requirements.

We also caution that a framework that requires NCAs to notify ESMA of certain delegation arrangements would effectively call into question an NCA's judgement in the evaluation and approval of the substance and oversight arrangements of an AIFM or UCITS management company in its jurisdiction. Such second-guessing of NCAs' authorizations would significantly undermine confidence and certainty in supervisors' decisions and lead to a "supervisor of supervisors" model in which the authority and decision-making of national supervisors regarding the firms under their direct responsibility is undermined.

If the EU determines to proceed with requiring NCAs to notify ESMA of certain delegation arrangements, we recommend that such a notification requirement be based on qualitative criteria, such as failure to comply with Articles 60, 75 and 82 of the AIFMD Delegated Regulation or a significant change in the extent of delegation since original authorization.

Proposed Changes Related to the Liquidity Management Provisions

The Commission has also proposed changes to the UCITS Directive related to LMTs and financial stability. Liquidity management and the use of LMTs has been and remains a priority for UCITS and their management companies. In evaluating potential changes to the UCITS Directive on these issues, the EU co-legislators should refrain from making extensive changes to the existing framework, including by measures that would supplant the expert judgment and discretion of the UCITS management company with those of a regulator. Instead, the Commission, Council and Parliament should focus on narrowly-tailored changes to the Directive to support UCITS management companies' ability to best respond to market events or stress.

ICI Global supports the effort to facilitate management companies' use of LMTs, including by Member States making the broadest feasible set of liquidity management tools available to UCITS. This would help a UCITS management company manage liquidity in ordinary and stressed conditions. Doing so in a permissive way would allow the management company to select tools appropriate for its UCITS and the market events that it may face.

We do not support, however, proposals that would restrain a UCITS management company's agility in responding to market events or stress. In particular, we are concerned about expanding the ability of NCAs and/or ESMA to compel a UCITS management company to activate or deactivate an LMT. Other than in extraordinary circumstances and limited to the home NCA's ability to suspend redemptions, any decisions to activate or deactivate LMTs should remain the responsibility of the UCITS management company. The management company is best positioned to determine when use of an LMT would be appropriate and how its activation could affect investors and other market participants.

Similarly, we do not support the proposal to require UCITS to adopt at least one of the specified LMTs (gates, notice periods, or redemption fees) because a management company should have the flexibility to

determine which tools are appropriate for the particular UCITS, and under which circumstances. Further, we are concerned that ESMA could draft related regulatory technical standards (RTS) on the definitions and considerations for selection and use of LMTs in an overly prescriptive way that could unnecessarily constrain managerial discretion on the use of LMTs.

As we further discuss in our attached position paper on LMTs in Annex 2, we believe that the experiences of UCITS during the March 2020 turmoil suggest that only targeted changes to the UCITS Directive are warranted. Our survey of ICI Global members' experiences during that time demonstrates that UCITS management companies ably managed liquidity in general, with exceptions for a small number of UCITS from select jurisdictions dealing with idiosyncratic circumstances regarding fund valuation. Accordingly, policymakers should focus on promoting UCITS' existing liquidity management practices and removing barriers to the use of LMTs, as appropriate.

Annex 1

Although, as stated above, we believe that there is no need for ESMA to separately collect from NCAs information on certain delegation arrangements, should EU policymakers proceed with such a requirement, we provide below recommendations on the type of information that could be collected:

- Questions regarding the NCA's assessment of the substance of oversight:
    - Does the management company have appropriate technical resources to oversee the number of UCITS/AIFs it manages?
    - Date of last assessment of the management company?
    - Number of management companies having appropriate technical resources to oversee the number of UCITS/AIFs they manage?
    - Number of management companies last assessed in: 2019 [ ], 2020 [ ], 2021 [ ], 2022 [ ]?
- Questions regarding the assessment of the individuals conducting oversight functions:
    - Does the management company have individuals with appropriate seniority and capability to oversee portfolio management and risk management?
    - Number of management companies having individuals with appropriate seniority and capability to oversee portfolio management and risk management?

Annex 2

The Commission is focusing on LMTs to promote the "protect[ion of] the value of investors' money, reduc[tion of] liquidity pressure on the fund and mitigat[ion] against broader systemic risk implications in situations of market-wide stress."[4] As we explain below, the Commission's objectives can be achieved through targeted changes to the UCITS Directive regarding the use of LMTs. Based on empirical data and relevant experience from the real-life stress test in March 2020, however, we see little justification for more extensive changes.

As a starting point, we wish to emphasize that liquidity management is a fundamental practice for UCITS and their management companies. Even before a UCITS is launched, the management company considers the liquidity of the expected investments in relation to the target investors and distribution channels. The UCITS management company also must ensure that the liquidity profile of the portfolio suits the specific redemption policy (e.g., redemption frequency). Once launched, a UCITS must maintain an ongoing liquidity management program and conduct tests to assess liquidity risk under exceptional circumstances.

Under the specific rules of each Member State's NCA, UCITS may use various LMTs to manage their liquidity when necessary to respond to market events or investor behavior.[5] Tools like swing pricing may be used more routinely and for reasons other than liquidity management, while others such as redemption gates and suspension of redemptions are appropriate only in extraordinary circumstances and, in fact, may never need to be employed.

ICI Global's views on the Commission's proposal are informed by a survey we conducted in 2020 of ICI members managing UCITS. The survey sought to better understand our members' experiences during the early part of the COVID-19 pandemic—such as how their UCITS navigated the swift and severe turmoil in global financial markets, which LMTs were employed, and which LMTs they had adopted but did not employ. Our results show that the overwhelming number of UCITS continued to operate normally and redeem shares on demand.[6] It is our understanding that the small number of exceptions were UCITS from select jurisdictions that generally were dealing with idiosyncratic circumstances regarding fund valuation, not an inability to meet redemption requests.[7] ESMA reached similar conclusions based on a review it conducted of certain investment funds, reporting that only 25% of UCITS with large exposures to corporate debt experienced net outflows above 10%. ESMA also noted that not all funds faced outflows and that almost 40% of all funds that ESMA sampled experienced net inflows during this period.[8]

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[4] *See* Proposal for a Directive at page 4.

[5] For a detailed discussion of UCITS' use of LMTs, including descriptions of the primary LMTs available to UCITS and their use during March 2020, *see* "Experiences of European Markets, UCITS, and European ETFs During the COVID-19 Crisis," Report of the ICI COVID-19 Market Impact Working Group (December 2020) (ICI COVID-19 Report) at 19-33, available at www.ici.org/pdf/20_rpt_covid4.pdf.

[6] *See generally* ICI COVID-19 Report.

[7] For more detail, *see* ICI COVID-19 Report at 32-33.

[8] *See* ESMA, Report on the Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds (November 2020), available at https://www.esma.europa.eu/sites/default/files/library/esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf. For this report, ESMA sampled a subset of investment funds in the EU "that have particularly large exposures to corporate debt and real estate markets."

Regarding LMTs, respondents to the ICI survey (who primarily domiciled their UCITS in Luxembourg, Ireland, and the United Kingdom) reported having adopted at least one of the LMTs permissible in those jurisdictions. During the COVID-19 stress period, 62 percent of respondents used at least one LMT—swing pricing, temporary borrowing, anti-dilution levies, redemption fees, notice periods, or dual pricing. None of the respondents' UCITS employed suspensions, gates, or in-kind redemptions.[9]

We support all Member States making the broadest feasible set of liquidity management tools available to UCITS. As ICI's survey findings underscore, UCITS managers employed a variety of LMTs as they navigated the March 2020 turmoil. We also know that one LMT—swing pricing—was used more frequently by survey respondents during March 2020, yet this tool is not available to UCITS in all jurisdictions. Harmonizing the availability of LMTs to UCITS across jurisdictions would facilitate liquidity management by allowing managers to select all tools appropriate for a UCITS based on its structure and redemption provisions, the asset classes in which the UCITS invests, its liabilities, and particular market conditions.[10] While complete harmonization of all LMTs for UCITS may be complicated by legal and operational differences among Member States, encouraging authorities in each jurisdiction to make the broadest feasible liquidity management toolkit available would advance the Commission's goals of protecting investors, reducing liquidity pressure on funds, and mitigating against systemic risk implications in situations of market-wide stress.

At the same time, some of the Commission's other proposals could limit or interfere with the ability of UCITS managers to respond to market events or stress. We are concerned that overly prescriptive changes to fund management could hinder, rather than advance, the Commission's objectives.

Required tools for UCITS. We see no justification for requiring all UCITS in all jurisdictions to adopt at least one of three specified LMTs—redemption gates, notice periods, or redemption fees.[11] As ICI's survey and ESMA's review confirmed, UCITS as a whole successfully navigated the unprecedented market turmoil in March 2020. We firmly believe that the adoption and use of any LMT should remain within the discretion of the UCITS manager, based on market and UCITS-specific factors (e.g., investment strategy and client base) and subject to supervisory oversight. Requiring the adoption of certain tools could have the effect of favoring some LMTs over others or lead to a regulatory expectation that those tools be used, irrespective of whether the manager believes such use is necessary.

Required standards. Similarly, we have misgivings about requiring ESMA to draft related RTS.[12] With respect to RTS "to define and specify the characteristics" of the LMTs, our concern is that ESMA may do so in an overly specific way, which could disrupt well-functioning regulation and existing UCITS practices. Although we favor the availability of a broad array of LMTs, we do not believe those LMTs must be minutely uniform

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[9] ICI COVID-19 Report at 31.

[10] By way of example, we understand that some UCITS management companies have considered whether the use of side pockets—an LMT not typically utilized by investment funds offered to retail investors—might be a way for a UCITS to manage the sudden and unprecedented valuation, trading, settlement, and liquidity challenges occasioned by Russia's invasion of Ukraine and subsequent impacts on holders of Russian securities.

[11] *See* paragraph 2 of proposed Article 18a.

[12] *See* paragraphs 3 and 4 of proposed Article 18a.

in their features and requirements. The descriptions of the eight LMTs in proposed Annex IIA generally would suffice to guide Member States' efforts, and we see no need for further elaboration by ESMA.

With respect to proposed RTS "on criteria for the selection and use" of suitable LMTs, our concern again is that an overly prescriptive approach could restrict UCITS' expert discretion in deciding whether and how to employ LMTs. These are highly fact-intensive and UCITS-specific determinations that are best handled by the UCITS themselves. Where ESMA could be constructive is in providing some general examples or case studies where activation of particular LMTs by UCITS was or could be advisable.[13] Doing so could provide useful guidance to UCITS managers while still ensuring that decision-making responsibility over LMT use, and liquidity management more generally, remains with the UCITS manager.

Reporting. We support carefully-tailored reporting by a UCITS to its home Member State only when it suspends redemptions or imposes redemption gates (or deactivates either).[14] Reporting should be limited to those LMTs whose activation is highly indicative of actual liquidity-related stress and beneficial to regulators given the burdens of reporting. Including other LMTs (e.g., notice periods and redemption fees) would capture activity that may not suggest stress. For example, a UCITS could use redemption fees or swing pricing as anti-dilution measures in the ordinary course of its operations. Overinclusive reporting of this activity would detract from, rather than contribute to, an NCA's ability to detect and monitor liquidity-related stress.

Moreover, requiring a UCITS to report to other entities (e.g., Member States in which it markets its units) would be duplicative and place unnecessary burdens on UCITS. We recognize that in periods of market stress, activation of an LMT with respect to a cross-border UCITS may be of interest to more than one NCA. We support providing clarity as to how NCAs will coordinate and share information in such circumstances. This could be achieved through ESMA guidance prepared in consultation with industry and the NCAs.

Activation/deactivation of LMTs. We have grave concerns about aspects of the Commission's proposal that envision expanding the ability of Member States and ESMA to authorize (or otherwise influence authorization of) a UCITS to activate or deactivate its LMTs.[15] Decisions to activate or deactivate LMTs should belong almost entirely to the UCITS manager, because it is most knowledgeable about the UCITS portfolio and its investors and therefore best-positioned to determine when use of an LMT would be appropriate. In this respect, ESMA's recent observations on money market funds also apply to UCITS generally:

> These [money market fund] LMTs should be activated by the manager of the MMF, and not by the authorities since there is a risk that when the authorities decide to activate a tool it would actually trigger the very contagion it intended to contain, because it could intervene too soon / too late / disproportionately given that the authority often does not, and not at all times, possess the detailed information on market situation and investor behaviour to be able to take action. The anticipation of the activation of LMTs by public authorities could also create the perception of a first-mover

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[13] For example, IOSCO has provided high-level examples of different LMTs, including pros and cons of tools and considerations for use. *See* IOSCO, Final Report, Open-Ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration (February 2018), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf.

[14] *See* paragraph 3 of proposed Article 84.

[15] *See* proposed paragraphs 2(b) and 3(a) through (f) of Article 84.

advantage and precipitate redemptions ahead of such decision (therefore prompting the need to such activation).[16]

The only permissible exception, in our view, is allowing a home Member State to compel a UCITS to suspend redemptions, under extraordinary circumstances as a last resort.[17]

ICI Global understands that the Commission and other policymakers want to ensure that UCITS are sufficiently able to meet their obligations to investors even during periods of market stress. The answer is not, however, to supplant the expert judgment of the UCITS manager with that of a regulator when it comes to decisions about whether and how to employ particular LMTs. The far better approach, in our view, is to focus on ensuring UCITS manager readiness to activate LMTs as necessitated by market conditions and investor activity. This can be accomplished by harmonizing the availability of LMTs for UCITS across jurisdictions, as the Commission proposes to do, and having NCAs and ESMA oversee UCITS manager readiness.

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[16] Final Report, ESMA opinion on the review of the Money Market Fund Regulation (14 February 2022), at 20-21, available at https://www.esma.europa.eu/sites/default/files/library/esma34-49-437_finalreportmmfreview.pdf.

[17] We note that the proposal appears to give the home Member State the ability to compel a UCITS to impose redemption gates even if the UCITS has not chosen redemption gates as one of its LMTs—a potentially impracticable provision. *See* proposed paragraph 2(b) of Article 84 and paragraph 2 of proposed Article 18a.