THE VOICE OF
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LONG TERM INVESTORS

On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

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AIFMD consultation

Accompanying paper on delegation

Note: *This paper aims to supplement the industry's official response to the European Commission consultation on the AIFMD review, in particular Question 47 and Questions 50-54, and intends to demonstrate the importance of delegation for the private equity and venture capital industry and to explain why there is no need to change the corresponding provisions in the AIFMD.*

Key points

- Article 20 AIFMD provides a robust model and a solid legal framework, particularly in combination with the additional rules set out in the AIFMD Delegated Acts. For example, delegation is *only* allowed to *authorised* entities and for objective reasons.
- Delegation is fundamental to how the private equity and venture capital industry operates. Delegation arrangements are aimed to improve efficiency and to facilitate fund managers' access to the relevant investment professionals and portfolio management expertise (e.g. in the country where they are investing). Any changes to the existing delegation rules should not lead to a reduction in investment choice in the EU.
- The need for flexibility to set up operational structures in financial centres and key marketing and deal-doing jurisdictions is instrumental, enabling fund managers to be close to the assets / the portfolio company and to tap into the expertise where the expertise is.
- Delegation is about a business operation model and business strategies, regardless of a firm's size (It is not about regulatory or administrative burden).
- Delegation is important from an EU, a non-EU and an intra-EU perspective.
- If delegation is severely restricted or even prevented, then there will be less choice for EU fund managers and EU investors and eventually possibly a loss of jobs.

Overview

It is essential that cross-border activity and flows of capital, whether between EU27 Member States or between the EU and other jurisdictions, are not impeded. A Capital Markets Union will not be realised if changes during the AIFMD review lead to the imposition of new barriers, including between Member States.

Invest Europe agrees it is important to ensure that applicable EU rules continue to be applied in a consistent manner by EU27 supervisory authorities. However, we are concerned that far-reaching changes to the AIFMD regime will:

- decrease the incentive and ability of Invest Europe members to expand their activities in the EU27, and may increase costs to investors with no corresponding benefit; and

- lead to the imposition of disproportionate requirements, or requirements with which compliance is practically impossible and which would undermine the private equity business model.

Any changes to the AIFMD delegation regime:

- Should take into account established market practice and the specific characteristics of the private equity industry, in particular the nature and use of delegation and advisory arrangements. Such arrangements, to EU or non-EU jurisdictions, are important for the private equity industry, not least because private equity funds almost always operate on a cross-border basis. The industry needs the flexibility to structure itself in such a way that the best skills and knowhow, wherever they are based, can be used. Delegation and advisory arrangements are deployed to enable fund managers to access the skills and expertise they need in the most efficient manner possible and without having to move people unnecessarily.

- Should not introduce new requirements or conditions to the conduct of financial services activities in the EU27 that run counter to fundamental principles of EU law (such as the free movement of services and capital, as protected by the Treaty) and/or are in breach of the freedom to conduct business guaranteed by Article 16 of the EU Charter of Fundamental Rights. They should not restrict firms that are seeking to exercise their right to establish within one EU Member State and to do business in another EU Member State.

- Should be proportionate and should ensure that unnecessary costs and regulatory burdens are not imposed on firms and potentially investors.

A distinction needs to be made between local, regional and internationally active managers. It is merely in the context of regional or internationally active managers that activities and services are spread across two or more jurisdictions.

- While cross-border activities are inherently more complicated and complex to set up and sustain, adding additional quantitative requirements is likely to cause material inefficiencies across multiple asset classes. Private equity and venture capital funds require very different skills and resources than property, hedge or credit funds. Fund-of-funds managers will again be subject to very different skills and operational requirements across the various asset classes.

- Moreover, the use of delegation arrangements will vary considerably across asset classes. Indeed, managers will operate different models which may have very different outcomes in terms of human or technical resources. Any attempt to legislate via quantitative criteria will pose significant operational risks and inefficiencies in a market where operational costs and expenses are closely monitored. In addition, imposing quantitative criteria across fundamentally different operational models and asset classes may only lead to unfavourable outcomes for the European asset management industry, either leading to oversized national players and non-existent small or medium sized managers.

The sector will altogether lose its ability to innovate, disrupt, be it through new teams, technologies or operational models. The European asset management industry must remain agile and flexible. A one-size-fits-all regulatory approach will encourage the most talented and innovative asset managers to locate their activities outside of the EU. EU investors would thus be disadvantaged through a reduction in access and choice, except for the more sophisticated investors who will be able to access non-EU products.

Use of delegation arrangements

Delegation arrangements, whether to EU or non-EU jurisdictions, are critical for the private equity industry and its operations. In particular, private equity funds by nature almost always operate on a cross-border basis: investments are usually made all over Europe; teams are very often located in different countries; and investors will also be dispersed across Europe and the wider world.

There are many reasons for delegating a function, such as:

(i) the delegate having staff with investment expertise in relation to particular investments to be made by the AIF. This expertise might relate to an industry sector (e.g. pharmaceuticals), investment type (e.g. bonds) or geographical location;
(ii) the delegate having administrative expertise such as legal, accounting or regulatory expertise which is relevant for administrative services;
(iii) the delegate having marketing expertise and/or potential contacts of use to the AIF and/or AIFM; and
(iv) delegation to other legal entities within an AIFM's group, where the relevant systems or expertise are housed in that other legal entity.

As regulatory requirements increase and teams are required to separate functions, more sophisticated and larger teams are required to support the fund industry. Delegation arrangements are not deployed in order to circumvent regulatory requirements but rather to be able to access the skills and expertise they need in the most efficient manner, wherever they are based. The ability for a number of funds to delegate to an entity with a particular expertise also allows the funds to benefit from economies of scale and operational efficiencies and therefore reduced costs for the funds and, ultimately, investors.

Existing regulatory regime

The use of outsourcing and delegation arrangements can be an efficient way to perform some functions or activities. Invest Europe understands why at the same time these practices can pose challenges to supervisory authorities and financial services participants themselves. This is why the AIFMD and Level 2 measures already provide an appropriate framework and extensive rules on outsourcing and delegation practices, and prohibit supervisory authorities from authorising an AIFM that is a "letter-box entity".

- AIFMD rules on outsourcing and delegation include requirements aimed at:

    - effective supervision, including access to data/information/premises (Article 79 of the Delegated Act);
    - continued responsibility of the AIFM for the delegated functions (Article 75 of the Delegated Act); and
    - management of conflicts of interest (Article 20(2)(b) of AIFMD and Article 80 of the Delegated Act).

- While we understand that regulators are concerned about the creation of letter-box entities, it is important to bear in mind that the AIFMD clearly allows the delegation of portfolio management (including the investment decision-making power) and of risk management to a third-country delegate[1], and that the mere delegation of AIFM functions does not of itself result in the AIFM becoming a letter-box entity. In the private equity area, the concept of "letter-box" entities has already been addressed in the AIFMD Level 2 measures, which include detailed provisions about delegation. The imposition of new conditions would create legal uncertainty and potentially lead to divergence rather than convergence in supervisory practices.

- Existing AIFMD rules do not differentiate between delegating to EU firms and non-EU firms. Invest Europe strongly feels that no distinction should be made as long as the necessary requirements of the AIFMD regarding delegation and those of the home Member State to which services are being delegated are met. In other words, delegation to third countries should be generally subject to the same requirements as EU delegation subject to the criteria set in Level 2.

- The use of a branch should not be treated as a delegation. Branches are not separate legal entities and there is no basis in the AIFMD for treating them as such. Assessment of the AIFM structure (and use of branches) should be part of the authorisation procedure foreseen under Articles 6 to 9 of the AIFMD.

- The AIFMD does not require all delegation arrangements to be in place in order to approve the authorisation of the AIFM. To the extent a group wants to start the authorisation process

[1] Art. 20(1)(d) AIFMD; Art. 78(3) AIFMD Level 2

before it has finalized the delegation arrangements, the AIFMD would allow it to do so and to seek approval for the delegation arrangements later.

Secondments

It is important to consider the different needs across different asset classes in an international context. The expertise and relevance of expertise cannot be limited to one or more EU jurisdictions. In an industry where competition is global, European asset managers must be able to tap into the talent pools that exist within the financial centres within and outside the EU and to be able to do so on a flexible basis in order to best support the needs of a particular fund. Limiting such access will cause EU managers to operate at a disadvantage.

Supporting tasks

We understand that there may be difficulties in assessing whether the delegation of 'supporting tasks' (such as legal or compliance tasks or research) is subject to the delegation rules set out in the AIFMD and UCITS Directive. While we would generally welcome clarification, we think that drawing the scope of activities subject to the AIFMD and UCITS Directive too widely would be counter-productive as it would increase costs for providers in areas which pose little risk to funds (and which would ultimately be passed on to investors) and would potentially reduce choice as not all service providers would be able to meet the additional requirements.

White label service providers

White label providers fulfil very important objectives for the industry altogether. Concretely:

- White label service providers permit smaller managers to start up operations in a regulatory environment where the regulatory entry level threshold is too high and marketing obstacles (without a passport) plentiful. Small and new managers will thus in many cases rely upon the operational set-up and expertise of well-established white label providers in order to scale up their activities which will often take many years and two or more fund generations.

- White label service providers may also permit non-EU managers to get a foothold in the EU market and to develop a market position over time. European investors will thus benefit from a larger offering and wider choice.

- White label service providers will also permit well-established managers to enter into new asset classes more quickly and efficiently. Setting up operations could take several years and be very costly and therefore white label providers provide flexibility for managers to provide a broader offering while keeping costs and administrative burden low.