AIMA

DEEPENING CAPITAL MARKETS IN EUROPE

THE ROLE OF THE ALTERNATIVE INVESTMENT MANAGEMENT SECTOR

A Policy Vision for 2024 and Beyond

MAY 2024

CONTENTS

FOREWORD

As we look ahead to the next 5-year term of the European Commission and European Parliament, it is fair to say that the European Union (EU) faces unprecedented challenges that will define the future for its citizens.

These challenges of our time – war, climate change, political instability, an ageing population, threats and opportunities from artificial intelligence – merit a comprehensive response and joined-up thinking. It is imperative that the EU continues to show strong leadership on the global stage regarding these issues. Similarly, continued EU stewardship is needed to ensure economic prosperity and social mobility for its citizens.

Crucially, the investment industry has both a role and a responsibility here. As guardians of investors' capital, we have an ideal viewpoint from which to offer our opinion. It is for this reason that we are putting forward this Policy Vision paper to contribute to the EU's thought-leadership as the workplan and priorities for the next 5 years are being developed. The full potential of Europe's capital markets remains to be realised. While progress has been made towards the development of the Capital Markets Union (CMU), much work remains to be done.

We believe our recommendations here will go a long way towards achieving that goal. As a starting point, we would like to highlight that the alternative investment industry is global in nature, as indeed is modern global commerce. Investment fund managers invest not only in the EU but all over the world. And the investors who put their money into the investment funds which our members manage are also based in all corners of the world. In this light, we would urge the EU to continue to demonstrate global leadership on the important issues, consistent with the policy of open, strategic autonomy. Sustainable economic growth is predicated upon developing deep and liquid capital markets. Fragmentation and protectionism are enemies of this.

With the right regulatory framework and incentives in place, we are confident that our members can continue investing and delivering capital to businesses and projects which are in need of financing. I look forward to working with you over the next 5 years to make this a reality.

Jack Inglis

CEO, AIMA

THE PURPOSE OF THIS PAPER

This paper has been prepared by the Alternative Investment Management Association (AIMA) and the Alternative Credit Council (ACC) to explain the role that the alternative investment management sector can play in supporting the EU's goal of developing a true Capital Markets Union (CMU), increasing cross-border investment throughout the EU and, importantly, channelling capital towards sustainable investments.

These ambitions are particularly important as the new European Commission and European Parliament will begin their legislative term in 2024 and unveil a new legislative agenda aimed at achieving these goals.

In this paper, we provide:

(i) An explanation of the alternative investment industry which we represent;

(ii) An overview of the contribution that the industry makes to the European economy and how this is done;

(iii) Our vision for how the EU can take concrete steps to deepen capital markets and work towards the completion of the CMU.

Our policy vision is built around 2 key themes:

(i) Funding the future of Europe,

(ii) Strengthening competitiveness of the EU investment industry.

Under these 2 themes, we set out 8 specific recommendations which policymakers can incorporate to work towards the completion of the CMU. We hope that this paper will provide the starting point for discussions with policymakers. We are committed to providing further, more detailed feedback in the future.

SUMMARY OF POLICY RECOMMENDATIONS

Theme 1: Funding the Future of Europe

Recommendation 1: Revive EU Securitisation landscape:

A reformed securitisation framework will help to reduce the EU's over-reliance on bank funding, one of the central pillars of the CMU project. The benefits of a more effective securitisation framework will be felt primarily by consumers, SMEs and mid-market companies in the form of better access to finance. Securitisation also has a huge potential to increase the capacity of the private sector to fund the sustainability transition whether it is through infrastructure, real estate or energy finance. Overall, the asset management sector needs to be put at the centre of the securitisation process both on the supply (creation and management of securitizations) as well as the demand side (investment in securitisation products).

Particular focus should therefore be given to clarifying the scope of the Securitisation Regulation, permitting fund managers to act as sponsors of securitisation and the proportionality of investor due-diligence and disclosure requirements. Reform of the Securitisation Regulation should be accompanied by concurrent reforms to the prudential treatment of securitisation for banks and insurance companies to ensure securitisation is able to play a full role in the financing of the EU economy.

Recommendation 2: Lower the Barriers for Loan Origination Fund Activity:

The recently concluded review of the Alternative Investment Fund Managers Directive (AIFMD) introduced a cross-border lending passport for loan origination funds (LOFs). This reform has the potential to significantly boost the amount of capital available to meet the finance and liquidity needs of EU businesses, permitting them to invest, grow and support job creation. The implementation of the new rules for LOFs must ensure that single market rights for cross-border lending by funds are not hampered by national restrictions or other regulatory barriers which diminish the progress that has been made. The AIFMD rules also need to be implemented in such a way as not to undermine the effectiveness of the newly introduced ELTIF framework.

Recommendation 3: Maintain Professional v Retail Investor Distinction:

Having robust wholesale and professional capital markets is key to financing the economy. Ensuring that retail investor regulation is not extended to those markets is key in lowering cost of intermediation. The proposed Retail Investment Strategy (RIS), by focusing on costs as a panacea for encouraging investment, will not contribute to the development of the CMU. Although recent amendments adopted by the European Parliament are welcome, we call on policymakers to take a fresh, broader look at the debate by examining all relevant issues aimed at encouraging retail participation in capital markets, not just cost.

Theme 2: Strengthening Competitiveness of the EU Investment Industry

Recommendation 4: Streamline, Harmonise and Centralise Regulatory Reporting:

The EU asset management industry is heavily burdened, unlike any other in comparison, by the proliferation of different reporting requirements. These requirements are made more complex by the fact that, often such reporting must be channelled to individual EU Member States rather than solely to countries where asset managers are authorised or to the European Securities & Markets Authority (ESMA). Information that is reported should be streamlined and collated between different regulators to improve efficiency. Under AIFMD, the European Commission will be responsible for adopting Implementing Technical Standards (ITS) including a template for reporting on systemic risk. We believe that the European Commission should ensure alignment with global reporting standards and avoid requiring disclosure of portfolio-level data. We also put forward suggested changes to the European Market Infrastructure Regulation (EMIR), the Short Selling Regulation (SSR) and the Markets in Financial Instruments Regulation (MiFIR) regimes that are often duplicative and overlapping.

Recommendation 5: Focus on Improving Market Liquidity and Resilience:

EU public markets are suffering from inadequate liquidity, undermining the most basic function of capital markets – efficient price formation. With an ever-increasing focus on building new layers of macro-prudential regulatory intervention in the asset management sector – layers that are not present and are not likely to be present in any other major financial centre – the EU risks stunting the growth of its most promising and innovative parts of the industry. Any interventions to improve financial stability should be undertaken with a lens of improving the diversity and liquidity of markets and should focus on market-wide resilience rather than individual institutions, or types of institutions.

Recommendation 6: Enhance EU Supervisory Architecture:

Greater harmonisation of practices and supervisory convergence is needed. In particular, the role of ESMA with regard to 3rd country elements should be enhanced and equivalence should be assessed at a technical level rather than at a political level.

Recommendation 7: Strengthen Good Practices in Legislative Process:

The practice of carrying out appropriate impact assessments prior to the adoption of a new rule – whether in the initial proposal or added at a later stage by the European Parliament or Council of the EU – should be regarded as indispensable. Proposed new laws should always be underpinned by strong evidence of market failure on the one hand or tangible benefits on the other hand.

Recommendation 8: Maintain Tax Neutrality for Investment Funds:

The principle of tax neutrality is generally recognised in EU law but we are conscious that there may be situations where the principle is put in doubt in the future, for example in discussions on the proposed Unshell Directive. The EU Pillar Two Directive outlines that appropriate treatment for funds should also include entities owned by the fund such as special purpose vehicles. Going forward, we believe the European Commission should adopt this principle across the board.

WHO ARE WE?

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than €3 trillion in hedge fund and private credit assets.

AIMA's members and the broader alternative investment industry perform an important social role by managing investments for pension funds, insurance companies, university endowments, charitable foundations, and other socially important investors.

AIMA's head office is located in London. We also have offices in Brussels, Washington DC, China as well as National Groups in Canada, Cayman Islands, Hong Kong, Singapore, Japan and Australia. AIMA's members comprise the leaders in the alternative investment management industry. They include hedge fund managers, alternative credit managers, fund-of-funds managers, prime brokers, administrators, lawyers and auditors.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage approximately €500 billion of private credit assets globally.

THE GLOBAL REPRESENTATIVE OF THE ALTERNATIVE INVESTMENT INDUSTRY, WITH AROUND 2,100 CORPORATE MEMBERS IN OVER 60 COUNTRIES

AIMA

THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

aima.org

WHAT ARE HEDGE FUNDS?

A hedge fund is an investment vehicle that manages money on behalf of institutional investors by pursuing investment strategies with all or some of the following characteristics:

(i) They may use derivatives (financial contracts whose value is linked to a related item such as oil, mortgages or currencies);

(ii) They may seek to magnify returns through borrowings;

(iii) They may use some form of short selling to hedge the risk of a market fall or crash;

(iv) They charge a fixed fee to manage the fund as well as a performance fee if returns exceed a predetermined benchmark;

(v) Fund investors are typically permitted to withdraw capital periodically, e.g. quarterly or semi-annually;

(vi) Usually, the managers who set up the fund are significant investors in the hedge funds themselves. This is described as “alignment of interests” or having “skin in the game”.

Today, there are roughly 8,000 hedge fund managers across the world managing around 25,000 hedge funds worth approximately €4 trillion. The industry employs close to 400,000 people worldwide.

WHAT ROLE DO HEDGE FUNDS PLAY IN CAPITAL MARKETS?

Capital markets are crucial in the financing of the economy. The alternative investment industry plays an ever-increasing role in the entire chain of investing and financial intermediation, contributing to market depth, sophistication, transparency and thus the ability of capital markets to support growth.

Much hedge fund activity may seem complex and confusing. It can be important to remind ourselves of some of the real-world examples of the benefits to the economy that hedge funds provide:

- Without interest rate derivatives trading by hedge funds, banks and other lenders would find it more risky or expensive to offer fixed-rate mortgages to their customers.
- Without commodity derivatives trading by hedge funds, airlines would find it more difficult to plan ahead and control the costs related to their fuel consumption.
- Without credit derivatives trading by hedge funds, banks would have to liquidate wholesale portfolios of Small and Medium-sized Enterprises (SMEs) loans and restrict finance to an already cash-starved sector.

By providing liquidity and taking on risks that others may avoid, hedge funds help to drive the engine of financial services, ensuring that capital reaches companies and borrowers.

WHO ARE THE INVESTORS IN HEDGE FUNDS?

There are a wide variety of investors in hedge funds, including pension funds, insurance companies, foundations, charities, sovereign wealth funds, fund-of-funds as well as high-net worth individuals (see Figure 1 below). Roughly two-thirds of all capital in hedge funds is allocated by institutional investors.

Most investors apportion a share of their overall portfolio to one or more alternative investment funds. This share typically ranges from about 5-10% of the total portfolio for public sector pensions to 30% or more for endowment funds.

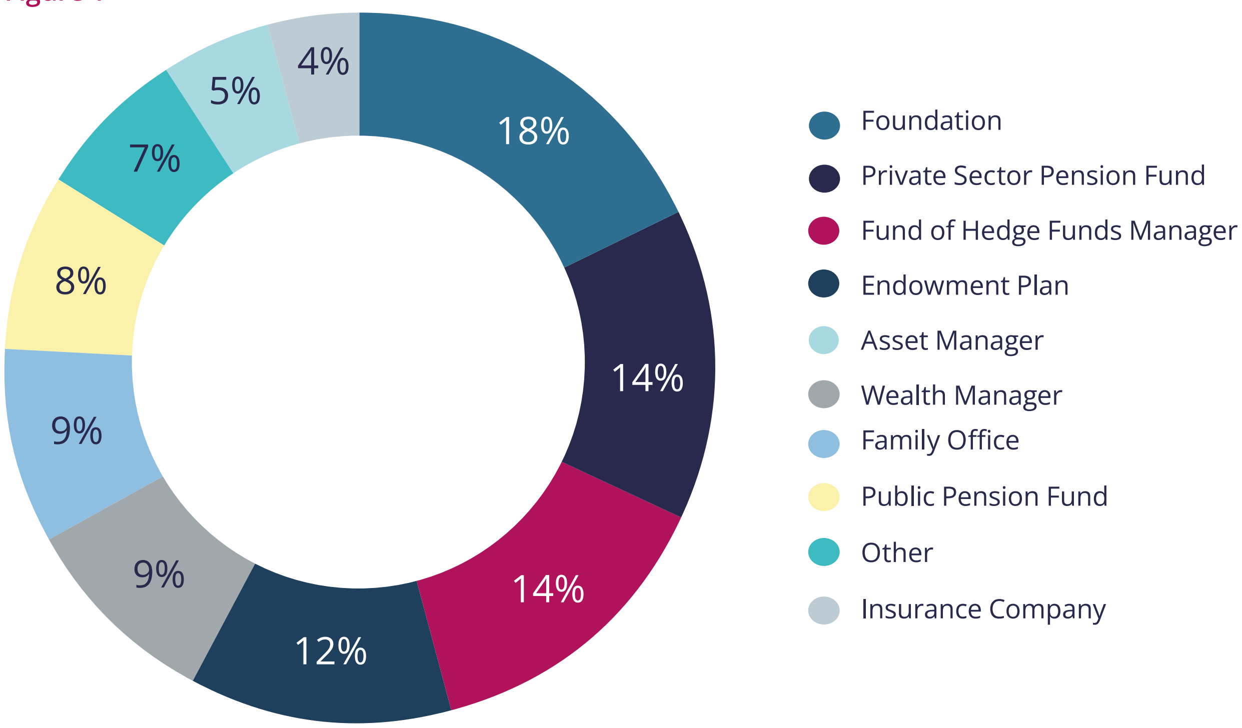
In the last 20 years or so, we have witnessed an increasing proportion of capital invested into hedge funds from pension funds (both private and public) on behalf of schoolteachers, doctors, nurses, private sector workers and university students.

This brings the alternative sector front and centre in the debate around the democratisation of finance.

Investors put their money in hedge funds as they are typically looking for:

- Competitive risk-adjusted returns, i.e. a way of measuring the value of the return (gain) in terms of the degree of risk taken.
- Downside protection: alternative investment funds are designed to provide greater protection against the large declines that the main asset classes including stocks, commodities and bonds sometimes experience.
- Flexibility and diversification: hedge funds usually have a broader investment strategy and can be counter-cyclical in nature, i.e. they produce a return even during difficult macro-economic environments.

Figure 1



WHAT IS PRIVATE CREDIT?

Private credit is an umbrella term used to describe the provision of credit to businesses by lenders other than banks. Most commonly, these lenders are regulated asset management firms pooling investor money into funds that are then used to finance respective businesses. The term private credit is often used interchangeably with phrases such as ‘private debt’, ‘direct lending’, ‘alternative lending’ and ‘non-bank lending’.

Private credit is an established but growing sector within the alternative investment market. It can be differentiated from other types of lending activity and investment strategies in various ways, including:

- **Bilateral relationships**: private credit lenders will often have a direct rather than an intermediated relationship with the businesses they are lending to.
- **Buy and hold**: the loans originated by private credit lenders are generally held to maturity by the original lender rather than traded.
- **A flexible approach**: core features of a credit agreement such as repayment terms or covenants will typically be structured to match the unique needs of the borrower.

Some of the more common private credit strategies include:

- **Corporate lending –** lending to performing operating businesses secured by business equity/cashflows.
- **Real estate –** lending to real estate projects/developers.
- **Infrastructure –** lending to infrastructure projects.
- **Asset based –** lending to business secured by assets (e.g. airplanes) rather than business-generated cashflows as in direct lending.
- **Trade finance –** lending to support trade in goods.
- **Structured credit** - lending with tranching of credit risk.
- **Speciality finance** - lending to support e.g. consumer credit or peer-to-peer platforms.
- **Venture debt** - to early-stage companies.

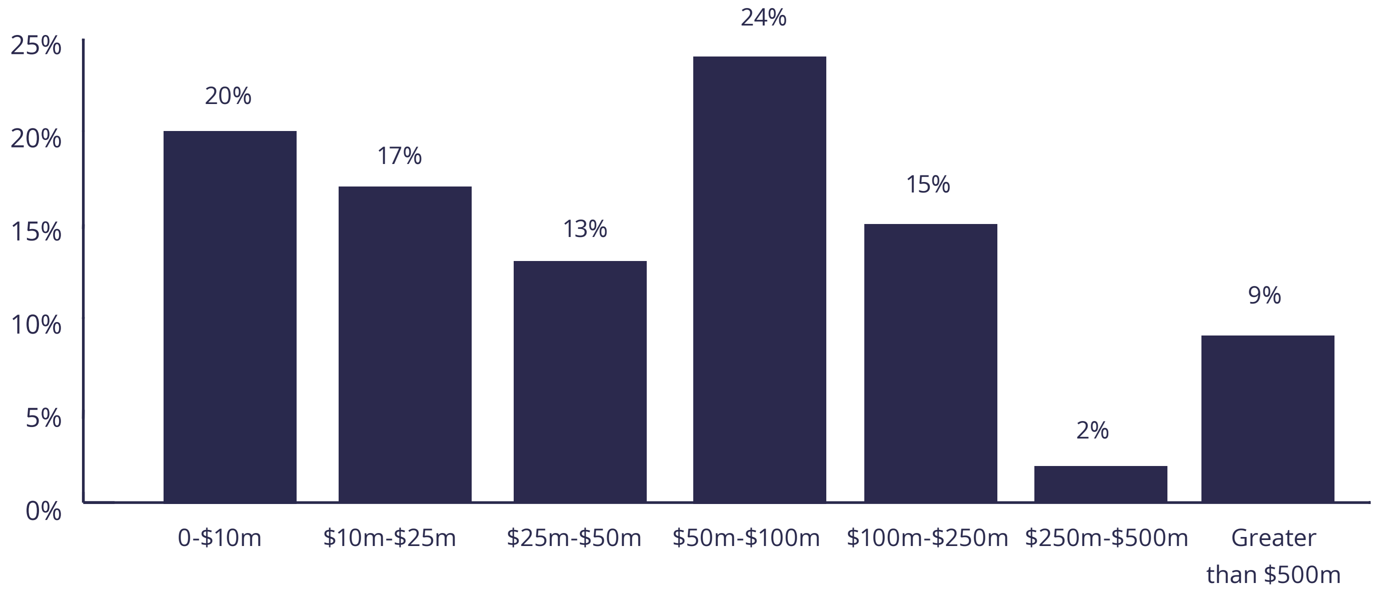
As with hedge funds, private credit is predominantly an institutional asset class with the most of the capital allocated to private credit strategies coming from pension funds, insurers or sovereign wealth funds. Family offices, high net worth individuals and private banks also invest in private credit but make up a smaller proportion of the overall investor base. We hope that the recently revised European Long-term Investment Fund (ELTIF) Regulation will provide a robust channel by which to support increased retail participation in private markets.

In November 2023, ACC published the 9th edition of its Financing the Economy report.[1] The Report showed that private credit managers lent an estimated $330bn globally in 2022. This lending was a vital source of finance and liquidity for SMEs and mid-market businesses as other credit markets retrenched.

1 https://www.aima.org/compass/insights/private-credit/financing-the-economy-2023.html

This is 60% more than the estimated $200bn they invested in 2021. While private credit funds used to lend mainly to mid-market businesses, as the sector has expanded it has become a vital source of finance for businesses of all types and sizes (see Figure 2 below)[2].

Figure 2 - What is the typical target loan size that you make within your private credit strategy?

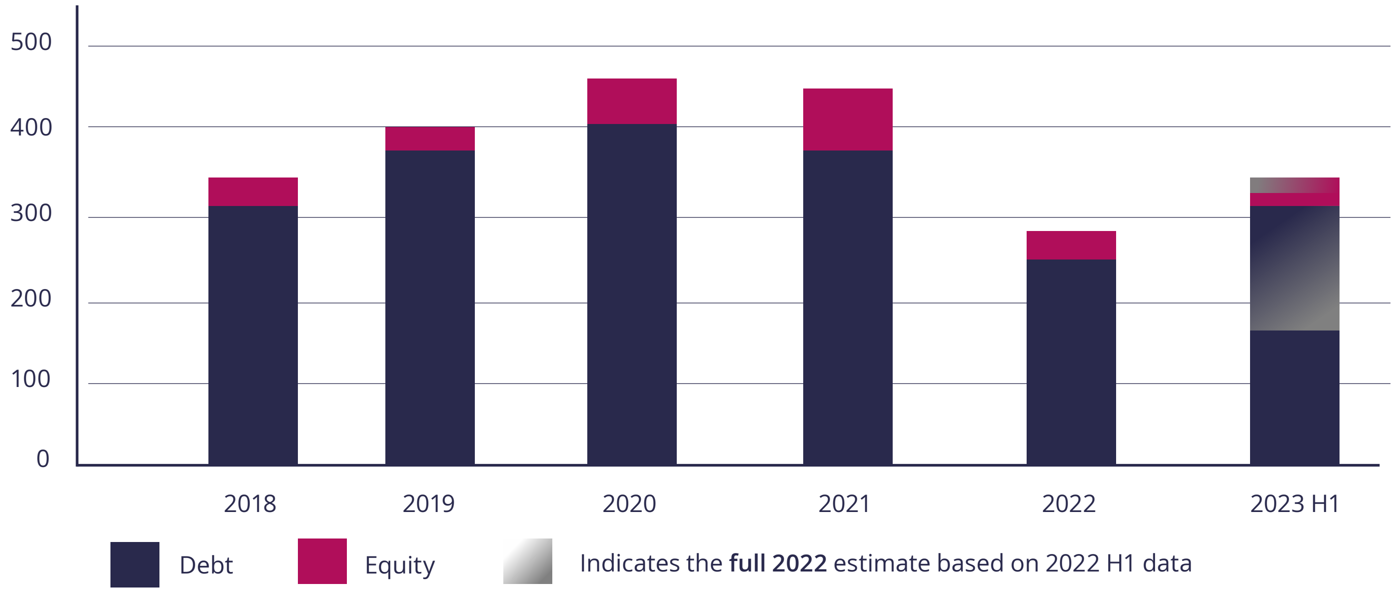


2 Ibid.

WHAT IS THE CURRENT STATE OF EU CAPITAL MARKETS?

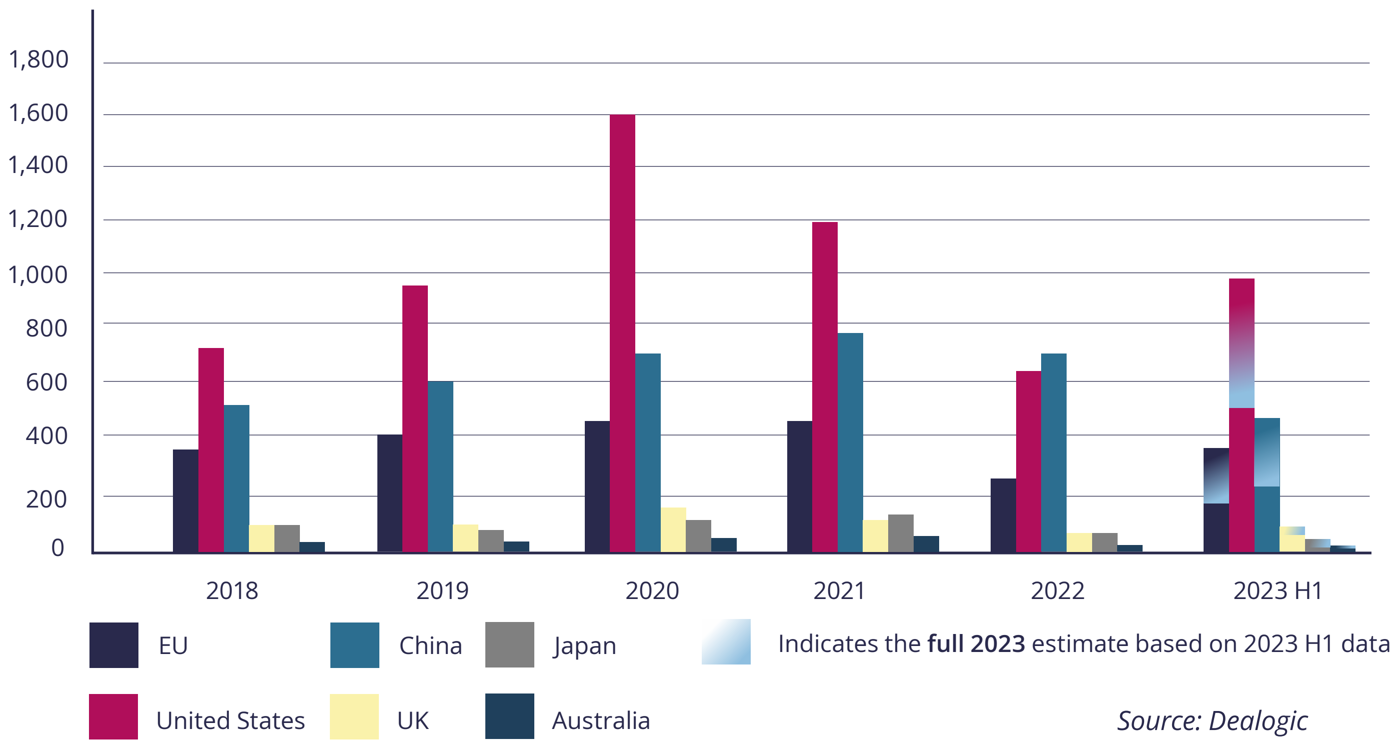
The following graphs illustrate that while levels of financing and investment increased up until 2020, they have steadily declined since and have not recovered to reach the levels that were seen pre-COVID.

Figure 3 - Breakdown of EU market finance (EUR bn)



Source: Dealogic, US FED, ECB, BoE and other European central banks

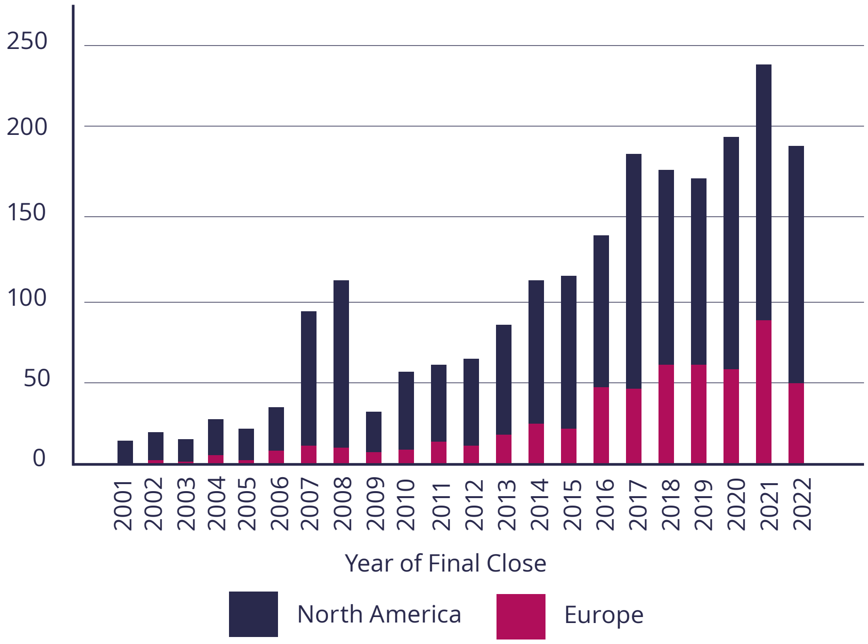
Figure 4 - Evolution of capital markets issuance by non-financial corporations in selected global regions (EUR bn)



Source: Dealogic

Figure 5 - Private Credit Funds (USDbn)

Capital Raised by Primary Geographic Focus



Source: Preqin Pro and Dealroom

It is clear that Europe still lags some way behind the US in terms of equity and debt financing. Despite this, there are reasons to be optimistic. From our perspective, the alternative investment industry has doubled in last 10 years to be worth €15 trillion today. Putting this in context, the entire asset management industry is worth approximately €100 trillion. All the indications are that alternative investments are set to continue growing in future.

Taking a broader perspective, while there is undoubtedly work to be done in terms of emulating the levels of capital deployment seen in the US, we should acknowledge the progress that has been made in creating the regulatory framework which will encourage cross-border investment however.

Rome was not built in a day, and we understand that ambitious projects like CMU will take time to complete.

With this in mind, how do we foresee progress being made on the regulatory front? We are proposing the following 8 recommendations which we believe will make a material difference to encouraging investment in Europe.

POLICY VISION: DEEPENING CAPITAL MARKETS IN EUROPE

Theme 1: Fund the Future of Europe

Recommendation 1: Revive EU Securitisation Landscape

Securitisation is a core feature of capital markets. It provides a mechanism by which illiquid loans originated by banks and finance companies are transferred to capital market investors. It is apparent that the EU securitisation framework is not functioning in an optimal way. Statistics comparing EU levels of securitisation with the US demonstrate how much potential there is still to be developed in the EU.

Securitisation markets grew significantly in the run-up to the 2008 global financial crisis (GFC), peaking at more than EUR 2tn in Europe in 2008-2009. Issuance then halted and the market size dropped significantly to EUR 540bn in Q4 2022. Unlike in the US where the total amount of securitisation reached USD 13.7tn in 2021, well above its 2008 levels (USD 11.3tn), the size of EU securitisation markets has remained below the pre-GFC level.[3]

A reformed securitisation framework will help reduce the EU's over-reliance on bank funding, one of the central pillars of the CMU project. The benefits of a more effective securitisation framework will be felt primarily by SMEs, which need greater diversity in the supply of finance to support them. A revived securitisation market is also necessary to achieve the EU's objectives in areas like green finance, energy transition, infrastructure and sustainable development, where it will be necessary to bring in a range of investors with different risk appetites to finance capital investment.

It is also important to recognise the genuine demand by borrowers and investors for an active, non-bank intermediation sector beyond the existing finance provided through banks and capital markets.

We strongly believe that the current EU securitisation framework should be modernised to address well-documented challenges with the existing rules.

3 https://www.esma.europa.eu/sites/default/files/2023-09/ESMA50-524821-2908_TRV_risk_analysis_-_EU_securitisation_markets_overview.pdf

This will permit securitisation to play its full role in the financing of the EU economy, while attracting international investment and supporting the EU's overall competitiveness.

We believe that these objectives can be achieved through the following changes to the securitisation framework:[4]

- **Modifying the definition of securitisation**: the broad definition used within the Securitisation Regulation has created additional compliance costs for asset management firms and investors who need to ensure everyday transactions (which are not typically considered securitisations) are outside of scope. The definition has also acted as a barrier for investors in blended finance strategies or those looking to finance public infrastructure investment alongside sovereigns. Modifying the definition can be achieved through specifying exclusions from the definition within legislation or guidance.
- **Due diligence obligations for institutional investors:** the detailed compliance requirements for institutional investors and associated risks are disproportionate and act as a significant barrier to investment in securitisation products while adding little value to the end investor.
- **Allowing AIFMs to act as sponsors of securitisations:** AIFMs now play a much larger role financing the corporate sector but they are prohibited from acting as sponsors of securitisations by rules which envisaged this only being performed by a credit institution or a MiFID licenced entity. Permitting AIFMs to act as sponsors will support the development of a mid-market securitisation market in Europe.
- **Distribution of third country AIFs investing in securitisation**: due to differences between US and EU implementation of globally agreed securitisation rules, EU investors are prohibited from investing in some US securitisation products such as mid-market collateralised loan obligations (CLOs). This restricts their ability to invest in the full range of securitisation products and compete with their global peers who do not face the same restrictions.
- **Amending the 'simple, transparent and standardised' (STS) criteria to include CLOs**: CLOs are currently not eligible for STS treatment despite such structures having many features that ensure an alignment of interest between the CLO managers and their investors, while also producing good performance and lower default rates than many other securitisation products.
- **Attracting prudentially regulated capital**: the combination of the Securitisation Regulation, Capital Requirements Directive and Solvency II Directive has significantly reduced the ability of prudentially regulated institutions to participate in this market despite the fact that many securitised products are a natural fit for insurance and bank liabilities, particularly in tranched structures which align with their risk appetite and support investment alongside other investors.

4 For more information, see AIMA Position Paper on securitisation reform, May 2024

Recommendation 2:

Lower the Barriers for Loan Origination Fund Activity

While AIMA has welcomed the final outcome of the AIFMD negotiations, it is important that vigilance is paid to both the manner in which the Directive is transposed in national legislation - to ensure a faithful implementation of both the spirit and letter of the rules laid down in the Directive - as well as the development of the Level 2 standards. These are issues which are not only relevant to the fund managers and the investors which allocate their capital to hedge funds and private credit funds, but concern EU competitiveness directly.[5]

The inclusion of the cross-border lending passport is the main achievement of the AIFMD review and a significant step forward in the development of the CMU. We urge the European Commission and Member States to be vigilant in honouring the intention and letter of the Directive by providing for a true cross-border passport for loan-origination funds in national transposition legislation, and also by providing for regulatory supervision to that effect.

Recital 13 of the revised AIFMD states the following:

"Directive 2011/61/EU should recognise the right of AIFs to originate loans. Common rules should also be laid down to establish an efficient internal market for loan origination by AIFs, to ensure a uniform level of investor protection in the Union, to make it possible for AIFs to develop their activities by originating loans in all Member States of the Union and to facilitate the access to finance by EU companies, a key objective of the Capital Markets Union ('CMU')."

While the updated text of AIFMD is clear in its intention as outlined above, there is no explicit reference to a cross-border lending passport. As a result, it is conceivable that some national transposition jurists may be of the opinion that Member States can therefore continue to apply local restrictions such as licensing requirements for the purpose of lending as per the Capital Requirements Directive (CRD) or rules prohibiting Special Purpose Vehicles (SPVs) and their activity. We call on the European Commission and Member States to fully embrace the concept of the passport and proactively break down barriers to its operation.

In the unlikely event that we do see restrictions contemplated or proposed by national authorities, then we would urge the European Commission to intervene here possibly in the form of non-binding questions and answers ("Q and As") which would provide guidance to national authorities. It is important that when we speak about completing the CMU that achievements which have already been made are not undone either by a lack of vigilance in transposition or the adoption of unsuitable Level 2 standards.

Several Level 2 standards on liquidity risk management are to be adopted under the new regime, including characteristics, selection and calibration of liquidity management tools (LMTs). Given the importance of these tools, and the unsuitable draft standards which ESMA recently submitted to the European Commission on the ELTIF Regulation,[6] we urge the European Commission and national authorities to be especially

5 For more information, see AIMA/ACC Position Paper: AIFMD Guiding Principles for National Transposition, May 2024

6 ACC comments on draft ELTIF guidance, August 2023

vigilant here to ensure that the final standards are proportionate and allow fund managers to continue their tried-and-tested methods of managing fund liquidity.

When developing any level 2 guidance on liquidity management for open-ended loan origination funds we would highlight that the ELTIF RTS liquidity management provisions are designed to take into account that ELTIFs can be marketed to retail investors. AIFs are primarily marketed to institutional investors and therefore, at a minimum, we think it is appropriate that any guidance on liquidity management for loan origination funds is no more prescriptive or restrictive than the ELTIF RTS.

Lastly, the interaction between the new AIFMD and ELTIF regimes will need to be clarified however as there are several instances where the regimes are expected to apply simultaneously but contain different rules. This includes the rules on leverage limits and the application of LMTs to open-ended funds.

Recommendation 3:
Maintain Professional v Retail Investor Distinction

As highlighted above in our explanation of the alternative investment management sector, the investors who put their capital to work in hedge funds and private credit funds are predominantly institutional investors. The bulk of our focus at EU level is on regimes which address changes to the rules for professional investors and it is this differentiation between retail and professional investors that we would like to see upheld in EU legislation. By their very nature, retail investors need much more legal protection than sophisticated investors.

In looking at the Retail Investment Strategy (RIS) that was released by the European Commission in 2023, the general direction of the reforms proposed would not contribute to the development of the CMU. We are concerned at the approach which appears to resemble price regulation. Lowering costs is not a panacea for financial participation.

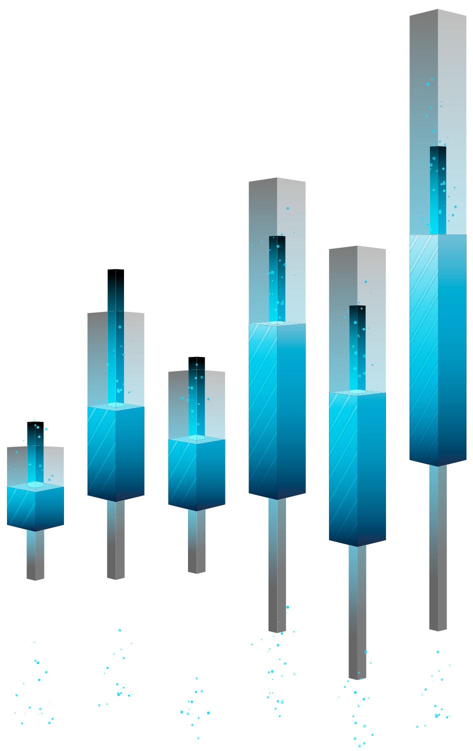
For alternatives, the main impact will be around the proposed changes to AIFMD. One of the core concepts of the package is the introduction of a "value-for-money" concept. This would require both manufacturers and distributors to ensure that products offered to clients deliver "value-for-money" by not deviating from a given benchmark with the aim of making the pricing process "more objective". Products that do not comply with these requirements would not be able to be approved. The benchmarks in question would be developed by ESMA and the European Insurance and Occupational Pensions Authority (EIOPA) on the basis of data on costs and performance of products reported by national authorities.

As a general point, we would emphasise that cost is only one of many measurements of value and that value means different things to different investors, especially for those sophisticated investors who will have different investment goals and risk-return appetites. We are also concerned by the new "best interest of the client" test. The proposed approach may lead clients to prioritise the "cheapest" product over others that could potentially offer them greater value. This does not strengthen EU competitiveness, in our view.

While we welcome the position of the European Parliament as being an improvement on the European Commission's proposal – as the former proposes an approach whereby firms conduct their value-for-money testing against benchmarks managed on a peer group evaluation as opposed to a centralised one – we believe that the focus on costs in the debate runs counter to the general principles of investment management, which is to offer bespoke, targeted solutions to different clients' needs. We therefore call on policymakers to take a fresh, broader look at the debate by examining all relevant issues aimed at encouraging retail participation in capital markets, not just cost.

Theme 2:

Strengthening Competitiveness of the EU Investment Industry



Recommendation 4:

Streamline, Harmonise and Centralise Regulatory Reporting

We fully support the principle that regulators, both at national and international level, need to collect and analyse comprehensive amounts of quality data in order to stay fully abreast of developments in the financial markets and identify any possible threats to financial stability that may arise. Over the past few years we have seen a steady increase in the quantity and precision of information that is communicated from investment fund managers to regulators. What we would like to see as an industry is a holistic approach whereby information that is reported is streamlined and collated between different arms of the regulator and between regulators themselves. This would allow for efficiency in both providing and using the information.

In particular, under the revised AIFMD, the European Commission will be responsible for adopting ITS specifying the format, data standards, methods and arrangements as well as the template for reporting under Article 24. In developing draft standards, it is possible that ESMA may recommend that reporting standards contain instrument-level granularity as a means of ensuring full disclosure to regulators. We fear that such a path would raise competitiveness issues as well as removing the possibility for compatibility with U.S. standards which focus on a risk-based exposure approach.

We appreciate that regulators would like to have as much detailed information as possible. We would stress that it is possible to deliver more information to regulators than is currently the case without having to disclose position and instrument level data. If ESMA does recommend such granularity and this is taken up, it will put the EU at a competitive disadvantage as EU AIFMs may be incentivised to move to the U.S. where the reporting standards do not provide a possibility for others to reverse-engineer their AIFs' investment strategies. This is particularly the case for quant funds based in France for example.

We believe the European Commission should adopt a proportionate approach in laying down the standards that ensures alignment with global reporting standards. We fear that if policymakers include instrument-level data here, this path would remove the possibility for compatibility with international standards, such as the ones set out by the International Organisation of Securities Commissions (IOSCO) in 2019,[7] which focus on risk-based exposures by asset classes and counterparties and which have already been implemented by other fund regulators.

As we mentioned at the outset, the alternative investment industry is global in nature. Having an approach whereby fund managers report the same information but in different formats in different jurisdictions is an unnecessary burden that can and should be avoided. This is also in line with our call for the EU to show global leadership by pursuing an open, strategic approach to business. In taking such a global approach, we would also submit that 3rd country fund managers would benefit from having a single point of reporting, ESMA. This would also enhance the EU supervisory architecture (see Recommendation 6 below).

We are also pleased to see the recent call for evidence by the European Commission on the Burden Reduction Package which aims to reduce the administrative burden on business by 25% overall. AIMA submitted its response in December 2023. [8]

Beyond AIFMD, we believe the following changes would bring additional benefits in other pieces of legislation:

1. Ensure there is only a single point of reporting Annex IV information for funds marketing under Article 42 (AIFMD)
2. Repeal the delegated act that modified the notification threshold in Article 5(2) of the SSR from 0.2% to 0.1% of issued shared capital, while introducing a central EU-level reporting channel for short positions. This should provide necessary reference data, including issued share capital information via ESMA.
3. Reform the structure of the reporting obligation under Article 9 of EMIR such that in transactions between clearing members and their clients, the clearing member would report the transaction, rather than requiring duplicate reporting. The framework should be further modified to require that reports are submitted to ESMA rather than commercial trade repositories.
4. Amend the obligation to report transactions under Article 26 of MiFIR such that where an investment firm is the client of an executing broker that is itself an investment firm, it may rely on reports submitted by its counterparty, rather than being required to submit its own duplicate report.

7 International Organization of Securities Commissions, “Recommendations for a Framework Assessing Leverage in Investment Funds”, FR18/2019 (December 2019).
8 AIMA response to European Commission call for evidence on rationalising reporting requirements as part of the Burden Reduction Package initiative, 28 November 2023.

Recommendation 5:

Focus on Improving Market Liquidity and Resilience

EU public markets are suffering from inadequate liquidity, undermining the most basic function of capital markets – efficient price formation. With an ever-increasing focus on building new layers of macro-prudential regulatory intervention in the asset management sector – layers that are not present and are not likely to be present in any other major financial centre – the EU risks stunting the growth of its most promising and innovative parts of the industry. Any interventions to improve financial stability should be undertaken with the lens of improving the diversity and liquidity of markets and should focus on market-wide resilience rather than individual institutions, or types of institutions.

The creation of truly deep and liquid markets will be key to a fully functioning and vibrant economy. One important plank for building such markets is to ensure that they have a multiplicity of participants offering a varied range of investments in different asset classes and strategies. Non-banks in general and hedge and private credit funds in particular are central to this, providing diversity in the assets available to investors and more choice for funding the EU economy.

This is a work in progress and its success risks being impeded by potential inappropriate regulatory actions. These initiatives do not properly recognise the nature and behaviour of both markets and their participants. Poorly crafted and very often unnecessary new policy initiatives aiming to reduce financial stability risks to the banking sector pose a genuine danger to the development of EU markets. They also often ignore the robust and tested regulation that has been in place for many years, often having been pioneered by EU institutions.

Of particular concern is a push for the so-called “macroprudential” regulation of non-bank entities such as investment funds. Any new EU macroprudential rules would be layered on top of existing EU and national level rules and regulations such as the AIFMD and MIFID in a way not seen in other major financial markets.

Macroprudential regulation means that regulators or central banks would have the power to intervene in markets and entire sectors. This would focus on ex-ante intervention rather than the current ex-post use of a tools or powers based on the judgement of the investment fund or its manager or by individual regulators. Part of this would be to “bucket” investment funds into cohorts depending on their assets or liquidity profiles. They could then be treated as a homogenous whole for macroprudential purposes.

Such an approach will create a false impression of commonality to allow a cohort to be treated in a uniform manner despite their using different financial techniques, asset mixes, subscription and redemption periods as well as having a different investor base. Once again, the EU will find its ambitions hobbled by disproportionate rules and interventions.

This will go hand in hand with further very detailed data requests for individual entities and positions. Such further reporting will swamp regulators with needlessly granular data rather than give a view of markets and potential risks to them.

In AIMA's view, the EU's capital markets will be deepened and developed by:

- A reliance on the current, very thorough and robust regulations instead of experimenting with blunt and untested policy interventions.
- Stepping away from introducing greater uniformity in fund structures and the way in which they are operated. Making funds conform to further product and asset regulations will reduce not increase opportunities for investing in the EU. There will be fewer types of investments available and they will have to be operated in a way that creates herding behaviour and allow more knowledgeable investors to gain unfair advantage over others.
- Not putting further caps on the use of financial techniques such as leverage. The measurement of leverage has subjectivity built into it and varies between types of entities. A more practical and profitable approach would be to limit leverage by reference to the amount of margin or collateral an investment fund must hold in relation to it.
- Gathering data in a way that shows the overall picture of markets so any potential risks can be identified. This will be done best by gathering aggregate data rather than detailed information on individual positions.
- Maximising the number of tools available for individual investment funds to manage their liquidity and other risks.

Recommendation 6: Enhance EU Supervisory Architecture

We recognise that in order to further integrate the CMU, greater harmonisation of practices and supervisory convergence is needed. While progress has been made as part of the European Supervisory Authorities (ESAs) review, we would support the increased transfer of powers from national level to EU level to the extent that clear benefits and efficiencies of such a transfer can be justified and to the extent that such a transfer does not involve conflicting or residual powers at the level of the national competent authorities (NCAs).

The most basic starting point in this discussion should be an increasing focus on simplification and centralization of reporting to ESMA. Of course, NCAs should be always able to obtain information under existing laws but ESMA should be the primary reporting point from which NCAs obtain the requisite data. This automatically creates harmonisation in reporting as even the most detailed harmonisation efforts based on legal definitions have still produced divergence in practice or technology.

In addition, the role of ESMA with regard to 3rd country elements should be enhanced. Ensuring that EU capital markets have a functioning regime in relation to third countries is of great importance for EU market development. We have previously expressed support for ESMA's increased role in assisting the Commission in preparing equivalence decisions pertaining to regulatory and supervisory regimes in third countries. We believe this should go further however and ESMA should be given a central role in ongoing monitoring of third country regimes, as we believe equivalence should be assessed at a technical level rather than at a political level. When it comes to third country central counterparty (CCP) supervision, we believe that empowering ESMA to be able to carry out third country CCP supervision in an effective manner is preferable to trying to shift trading and clearing volumes into the EU.

Recommendation 7:

Strengthen Good Practices in Legislative Process

As we have highlighted, the investment management industry is global in nature. In line with the EU's continued leadership on important issues, we would like to see more of a global viewpoint being taken when it comes to proposing and negotiating legislation.

As a general principle, rushed lawmaking is bad lawmaking. The practice of carrying out appropriate impact assessments prior to the adoption of a new rule – whether that rule is put forward in the initial European Commission proposal or added at a later stage by the European Parliament or Council of the EU – should be regarded as indispensable.

Unfortunately, we have seen several examples in the current legislative term of new laws being adopted with no published research and analysis of why exactly they are being adopted, and what the impact of their adoption will be. Proposed new laws should always be underpinned by evidence. The reviews of AIFMD and the EMIR are cases in point of heavy-handed intervention that has nearly resulted in extreme market disruption. One possible method of enhancing best practice would be for the European Commission to conduct pre-consultations with Member States on the basis of a detailed draft of legislative proposals. This would ensure a more targeted and coherent debate in the Council of the EU after the adoption of a proposal.

Crucially, this would allow for a screening of technical issues way before the legislative process starts. One of the weakest points of the existing legislative process is its lack of attention to detail that is not 'political'. This leads to the EU effectively adopting rushed and 'unfinished' legislation. Allowing the scrutiny of the actual legal text prior to the proposal stage, takes away the pressure to reach negotiation milestones that often sacrifices technical soundness for political expediency. Problems are then left to ESMA and NCAs to deal with but usually without necessary powers to do so.

In a similar vein, we have seen instances where co-legislators at EU level agree a high-level compromise on a proposal in trialogue negotiations, announce that there is a final agreement, and then agree to work out the remaining details later. Unfortunately, this sometimes results in a situation where the remaining details are quite important for the relevant industry and are not given enough attention to find an appropriate outcome. We urge policymakers to give sufficient time to these important pieces of legislation. It can be even beneficial to revisit the old mantra "nothing is agreed until everything is agreed."

In order for the EU to show global leadership on important issues, recalibrating the legislative process to ensure utmost adherence to best practices is an important consideration. This would also encourage other jurisdictions outside the EU to follow suit. Unfortunately, we have seen examples in other jurisdictions of the erosion of long-established norms and practices with regard to legal checks and balances in the legislative process.

Recommendation 8:

Maintain Tax Neutrality for Investment Funds

Investment funds, including alternative funds, are designed to maintain as far as possible tax neutrality. This is the principle that an investor should have broadly the same tax outcome as if investing directly in the same assets as the fund. Funds are generally structured as tax-neutral vehicles thereby allowing investors to be liable to tax once in their own jurisdiction.

While this principle of tax neutrality is generally recognised in EU law, we are conscious that there may be situations where the principle is put in doubt in the future. For example, we have seen discussions on the proposed Unshell Directive on whether the exemption for regulated financial undertakings should be maintained, and in particular whether the categorisation of asset managers should include the legal entities owned by the investment fund for the purpose of fulfilling the investment mandate.

This position (i.e. including entities owned by the fund) is fully consistent with the Pillar Two Directive which states that it shall not apply to excluded entities which includes, amongst others, investment funds and an entity where at least 95% of the value of the entity is owned by an investment fund. The rationale for this exclusion is explained succinctly in the Organisation for Economic Cooperation & Development (OECD) Report on Pillar Two Blueprint:[9]

"The final part of the definition recognises that an Investment Fund may use special purpose vehicles to hold assets or to make certain investments. Such entities or arrangements essentially function as part of the infrastructure of the fund itself, and should be treated as part of the Excluded Entity. The exclusion for special purpose vehicles does not extend to entities that carry on or otherwise have responsibility for managing a trade or business of the MNE Group itself. The definition also provides for cases where the entity or arrangement is held by more than one separate Investment Fund, or by one or more Investment Funds together with another Excluded Entity such as a pension fund. The definition also accommodates cases where, for regulatory or commercial reasons, the fund manager may be required to hold a de minimis shareholding in the entity or arrangement."

Going forward, we believe the European Commission should adopt this principle across all pieces of tax legislation in order to ensure tax neutrality for investment funds. For more information, see our recent letter submitted to the European Commission.[10]

9 OECD Report on Pillar Two Blueprint, October 2020
10 AIMA Comment Letter to European Commission DG TAXUD on Withholding Tax & Unshell Directive Proposals, November 2023

FIND OUT MORE

Thank you for taking the time to read our Policy Vision Paper.

To find out more about our industry and priorities, please visit www.aima.org or email info@aima.org.

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