THE INVESTMENT ASSOCIATION

POSITION PAPER:

THE DELEGATION OF INVESTMENT MANAGEMENT FUNCTIONS

Recently, the European Commission published its consultation paper as part of its review of the Alternative Investment Fund Managers Directive (AIFMD). It concludes the AIFMD has contributed to the creation of the EU's AIF market, provided a high level of investor protection, and facilitated the monitoring of financial stability risks. It also seeks feedback on the appropriateness of current delegation rules, and whether these could benefit from clearer drafting, particularly those designed to prevent the use of 'letter-box' entities.

This Position Paper sets out our response, concluding that the current delegation rules already provide national authorities with sufficient clarity, with delegation functioning well under proper supervision and local oversight. It highlights the importance the pan-European investment management industry places on delegation, how this is integral to the effective operation of the AIFMD and the competitiveness of the EU AIF market internationally, and the implications for European savers should additional qualitative or quantitative measures be introduced.

IA POSITION

The ability to delegate is a long-established international norm which is essential to the efficient functioning of the EU's AIF market, and funds market more broadly. Delegation is demonstrated to perform effectively under robust supervision and local oversight, including during the recent market crisis in March 2020. It allows savers to access global expertise and investment opportunities, whilst benefitting from increased choice and high levels of investor protection due to strict adherence to EU rules, oversight, and supervision. The IA strongly cautions against the introduction of additional qualitative or quantitative criteria on delegation beyond those already within the AIFMD on the following basis:

- Intervention in the form of such changes would be **disproportionate to the perceived risks to investors and is not supported by any evidence submitted by ESMA nor the Commission**. The IOSCO Guidelines on the delegation of functions (2000) make clear that whilst the location of the activity is an important consideration, delegation rules should focus on ensuring national authorities can obtain the necessary information to fulfil their statutory obligations, delegating entities remain accountable for all activity, and that delegating entities retain sufficient expertise to supervise the delegated activity and intervene if necessary, including terminating any delegation arrangement.

  These considerations are enshrined in Article 20 of the AIFMD, which is supplemented by Article 75 of the Commission Delegated Regulation (EU) No 231/2013 (AIFMR). Irrespective of Brexit, **EU AIFMs will remain subject to such measures, and these will continue to guide national authorities when considering whether to allow certain functions to be delegated.** Significantly, Brexit does not change the contractual relationship between AIFMs and the receiving entity, nor the legal obligation to oversee all delegated tasks, ensure compliance with AIFMD and its implementing measures, and where it concerns portfolio management, this is carried out per the investment policy.

- Secondly, when read in conjunction with **Article 75 of the AIFMR, Articles 76 - 82 provide national authorities with clear and coherent criteria to assess all delegation arrangements**. Article 76 requires that AIFMs must objectively justify any delegation of functions, taking into account the optimisation of business functions, cost savings, expertise,

and access to trading capabilities. This is complemented by Article 82, which details how a local authority should then determine whether such delegation could lead to the creation of a 'letter-box entity. This includes, among other matters, the types of assets the AIF invests in, and the type of investment strategy employed. The application of the criteria is the subject of detailed guidance to national authorities by ESMA in its 2017 Legal Opinion to ensure a convergent approach to the supervision of delegation. These requirements have been incorporated by national authorities through specific guidance (see, for example, the CBI's CP-86 or the CSSF's 18/698).

Introducing additional qualitative or quantitative criteria would be not only disproportionate given the level of attention given to this topic both by ESMA and by national authorities, but would also be inconsistent with international best practice. As discussed in the 2018 ESA review, **national authorities remain best placed to understand the complexities of the local market, with proximity an essential advantage in assessing whether delegation can be justified given an AIFMs structure and investment strategy** in accordance with Articles 76 (1) and 82 of the AIFMR. Furthermore, the EU's Supervisory Convergence Network established in response to Brexit examined hundreds of "live" delegation cases to third countries submitted to it by local authorities. Importantly, no individual case of delegation was challenged, nor an AIFM denied the right to delegate, out of investor protection or financial stability concerns, suggesting additional clarification of these existing criteria is not required.

- Thirdly, introducing limits on the maximum extent of delegated activity, or the ability to delegate specific would **undermine the economies of scale carefully established by AIFM's optimising their operations, and introduce new barriers to other providers from entering the market, in turn limiting competition and innovation in the EU's AIF market.** Noting AIFs are typically marketed to institutional investors with sophisticated diversification and asset allocation strategies, the current flexibility in the regime allows local authorities to balance investor protection requirements with the need for AIFMs to be able to utilise global centres of expertise or access other specialist functions. Additional restrictions would impair the ability of AIMFs to fulfil their legal obligations to act in the best interests of its investors under Article 20 (e) of AIFMD, and raise costs for investors in EU AIFs, reducing the total available capital to be invested in the European post-pandemic recovery.

  The ability to delegate is a critical enabler for the European investment management industry and is a key feature of the AIFMD. We share international concerns about the broader reputational impact restricting the ability to delegate specific functions may have on the EU AIF market over the longer-term. The AIFMD is widely regarded as a global financial services success story, and under effective supervision, continued international investment into AIFs will be crucial in the development of the CMU. **Unjustified restrictions on the ability to delegate specific functions, in part inspired by political issues associated to Brexit, will weaken the attractiveness of the EU's AIF market** for firms on an international basis, such as North America and Asia, and could risk similar measures being introduced by other major financial centres to the detriment of European savers and investors.

The departure of the UK from the EU's supervisory architecture may give rise to concerns regarding sharing of information acting for EU AIFMs,. Where the delegation concerns portfolio management or risk management, the competent home authority of the AIFM and the supervisory authority of the delegated entity must have concluded a cooperation arrangement prior to such activity being carried out. We recall that on 17 July, the FCA and ESMA reaffirmed that the MoUs agreed in February 2019 remain relevant and appropriate to ensure continued cooperation and exchange of information post-Brexit so as to ensure effective supervision of delegated activity.

WHAT IS DELEGATION?

The delegation, or 'outsourcing', of investment management activity is critical to the efficient operation of the European investment management industry and has been an integral factor in the successful development of the EU's AIF market. In the same way a plane manufacture can utilise global supply chains to source engines from one provider, wings from another, and electronics from a third, delegation allows savers to access global centres of expertise and investment opportunities, whilst benefitting from cost savings and high-levels of investor protection through strict adherence to EU rules, oversight, and local supervision.

Delegation is widely used by EU AIFMs to access portfolio management, distribution, fund administration, and IT support functions, with each AIFM using delegation in different combinations to support their own unique business models. Importantly, under the current AIFMD regime, risk management and portfolio management functions may not both be delegated, ensuring AIFMs retain sufficient substance locally to intervene if necessary. Due to the increasing sophistication of financial markets, this ability to structure operations in the most efficient manner is integral to the competitiveness of the EU AIF market. It allows AIFMs to acquire expertise in fields AIFMs may not possess themselves, or where they believe that investors will benefit from utilisation of third-parties and the economies of scale that can be created. It also allows firms to ensure 24-hour coverage of global markets, expanding the investment opportunities and products that can be offered investors in EU AIFs, in turn fostering further specialisation and innovation.

Beyond the associated benefits to investors in EU AIFs from being able to access global investment expertise, critically delegation also allows EU AIFMs to optimise their administrative and operational activity by being able to pool core functions together into a smaller number of hubs. The economies of scale that can then be created helps to lower the costs to savers for accessing these services at a time when Member States are facing pressure on the provision of pension benefits to their citizens. Lower costs also ensures that more capital is available for investment – a key issue in the aftermath of the COVID-19 pandemic as set out in the recent Commission Action Plan on the CMU.

HOW IS THIS ACTIVITY GOVERNED?

Delegated activity is carried out in accordance with the Principles on the Delegation of Functions published by the International Organisation of Securities Commissions (IOSCO) in 2000. With the agreement of the international community, these principles have successfully governed delegated activity with three core objectives in mind, namely the protection of investors; ensuring markets are fair, efficient and transparent; and the reduction of systemic risk. These principles have been put into effect within the various national regulatory frameworks through a range of requirements including, but not limited to, the following items: minimum net capital; sufficient human and technical resources; "fit and proper test", educational requirements; and specific disclosure requirements.

In the EU, these IOSCO principles are enshrined in both Article 20 of the AIFMD, which in turn is further complemented by Article 75 of the Commission Delegated Regulation 231/2013. These both require, among other matters, that EU AIFMs when considering to delegate any function ensure the delegation structure used does not allow for the circumvention of the AIFMs responsibilities or liabilities; the obligation of the AIFM towards investors in its funds is not altered in any way, that delegated activity is carried about per the AIFMD and its implementing measures, and critically that at all times the AIFM retains the necessary expertise and resources to supervise the delegated activity properly.

The incorporation of the IOSCO principles into the AIFMD ensures that EU AIFMs operate within a robust and stringent regulatory framework that not only assists with the proper monitoring and limiting of micro-prudential risks associated with delegation, but which also promotes a common approach to protecting investors in AIFM managed funds both within the EU and beyond. Specifically, Articles 76 – 82 of the AIFMR provides local authorities with clear set of criteria which much be considered when assessing delegation arrangements and whether permitting such activity could risk the AIMF concerned being considered a letter-box entity. These are, in turn, the subject of detailed guidance to national authorities by ESMA in its 2017 Legal Opinion to ensure a convergent approach to the supervision of delegation. The sum of these requirements has in turn been incorporated by national authorities through specific guidance on required substance (see, for example, the CBI's CP-86 or the CSSF's 18/698).

The assessment of a delegation structure is a complex exercise that must be based on a series of criteria for the competent authorities to form their judgement. However, as recognised in the recent ESA review, it is the national authority which is best placed to assess whether delegation arrangements can be justified on an objective basis considering not only these criteria but its own understanding of local requirements and the AIFMs operations. The combination of criteria and local knowledge is necessary to consider the variety of fund structures and investment strategies across the EU, noting that ESMA may develop guidelines to ensure a consistent assessment of delegation structures across the EU or use its peer-review network to assess compliance with its guidance.