

GREAT FUND INSIGHTS

AIFMD Review Proposal Published: What are the key takeaways for asset managers?

December 2021

What is the AIFMD Review about?

On 25 November 2021 the European Commission (the **Commission**) published a proposal for a directive amending the Alternative Investment Fund Managers Directive (**AIFMD**) and the Undertakings for Collective Investment in Transferable Securities (**UCITS**) Directive as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds (the **Proposal**).

The Proposal is part of a broader package which includes a proposal for a regulation amending the ELTIF Regulation and a directive amending certain Directives as regards the establishment and functioning of the European single access point (ESAP).

What is the context of the AIFMD review?

The AIFMD, which took effect in 2013, contains a review clause for the Commission to commence a review in July 2017 of its scope and application (the **Review**).

Partly as a result of lengthy Brexit negotiations, the Commission only submitted its preparatory report (the **Report**) to the EU co-legislators for the Review in June 2020. The Report concluded that, while the AIFMD generally met its objectives to strengthen investor protection and enhance financial stability, certain areas could be improved and certain regulatory gaps could be filled.

ESMA subsequently shared its views in a letter dated August 2020 where it recommended 19 priority topics to be considered for the Review, including harmonisation of the AIFMD and UCITS regimes, delegation and substance, liquidity management tools, leverage, the AIFMD reporting regime and data use and harmonisation of the supervision of cross-border entities.

In October 2020, the Commission launched a public consultation on the Review (and on harmonisation of the UCITS framework with AIFMD) (the **Consultation**) to receive stakeholder feedback. Following this part of the Review process, the Commission has now published the Proposal.

What has been the industry's response to the Review so far?

In total, there have been **132 responses** to the Consultation, including from all the main industry and trade associations.

A widely held industry view is that the AIFMD has generally functioned well and largely achieved its objectives in terms of establishing an effective supervisory regime for alternative investment fund managers (**AIFMs**) and has ensured high levels of investor protection and facilitated the creation of the EU alternative investment fund (**AIF**) market.

With the consensus being that the AIFMD has created a strong regulatory and supervisory framework for EU AIFMs, the majority of stakeholders are reluctant to undergo a sweeping overhaul of the existing regime, which everyone is used to and for which the implementation has proven to be challenging and costly. A key suggestion, which was part of the feedback provided by many respondents to the Consultation, was to leave the AIFMD Level 1 alone and for any changes to be made to Level 2 through delegated acts or supervisory guidelines.

What are the key takeaways from the Proposal?

The Commission has taken into account in its Proposal the feedback from the majority of the respondents wishing to harmonise liquidity management tools (**LMTs**) and to bring central securities depositories within the custody chain as the depository's delegates. The Commission has also postponed the introduction of a depository passport, which the majority of respondents rejected.

The Proposal includes a new regime for loan origination funds and adds certain conditions to the delegation and substance arrangements of asset managers, despite many key players, including the largest trade associations, voicing that there was no need to introduce new rules such as these.

The Proposal is still in draft form as it makes its way through the European legislative process, so the updates in this Alert are subject to change during that process.

In this Alert, we provide a high-level overview of the Proposal in its entirety.

1. New framework for loan origination funds

Loan origination funds are funds that provide credit (ie originate loans), as sole or primary lenders to borrowers. The Commission recognises that loan origination funds can contribute to supporting the European economy by offering market-based financing alternatives to companies.

The Proposal introduces common rules applicable to AIFMs managing loan origination AIFs in order to create a level playing field, improve risk management and increase investor transparency.

Under the Proposal, AIFs would only be allowed to originate loans under the following conditions:

- **Conflicts of interest:** the loan origination fund cannot lend to its AIFM, the AIFM's staff or delegates or its depository.
 - **Retention obligation:** the loan origination fund must retain on an ongoing basis 5% of the notional value of the loans it has originated and subsequently sold on the secondary market.
 - **Closed-ended:** the loan origination fund must be closed-ended. For the purpose of this restriction, any AIF that originates loans and in respect of which the notional value of originated loans represents more than 60% of its net asset value would be considered a "loan origination fund".
- **Loan origination policies and procedures:** their AIFM establishes, maintains up-to-date, and reviews at least once a year, policies and procedures for the granting of loans, the assessment of credit risk and the monitoring of credit portfolios.
 - **Concentration limit:** the percentage of the AIF's capital that may be lent to a borrower that is either a financial undertaking (as defined under the **Solvency II Directive**), an AIF or a UCITS is capped at 20%. It is worth noting that the concept of "AIF's capital" is not defined under the Proposal and it is unclear whether this limit is meant to apply by reference to the undrawn commitments or the (net or gross) assets of the AIF.

2. Extended AIFM functions and services

It is proposed to add to the list of activities that AIFMs can provide when managing an AIF (in Annex I of the AIFMD):

- loan origination (even if, in practice, it is the fund itself which originates loans); and
- the servicing of securitisation special purpose entities (SSPEs).

AIFMs with a MiFID top-up licence would also be authorised to provide two additional ancillary services (in addition to discretionary portfolio management, investment advice reception, safekeeping of fund units and transmission of orders, so-called MiFID top-ups), namely benchmark administration and credit servicing.

The Proposal sets out which provisions of the MiFID framework apply to the provision of ancillary services under Article 6(4) AIFMD (where those ancillary services are being provided in relation to MiFID financial instruments). Article 6(6) is being amended to expand the provisions of MiFID that apply in relation to the provision of ancillary services but also makes clear that MiFID will not apply where the ancillary services are either of the two new ones – ie benchmark administration or credit servicing.

3. Liquidity management tools for open-ended funds

It is proposed to include in the UCITS Directive and the AIFMD a list of available LMTs, ie suspension of subscriptions and redemptions, gates, notice periods, redemption fees, swing pricing, anti-dilution levies, redemptions in kind and side-pockets.

Under the Proposal, AIFMs of open-ended funds and UCITS management companies would be required to:

- provide in the fund rules or in the instruments of incorporation of the AIF or UCITS (the Proposal is referring to the instruments of incorporation of the AIFM but we assume that this is meant to be a reference to the AIF) at least one of the following LMTs: redemption gates, notice periods or redemption fees in addition to the possibility of temporarily suspending redemptions;
- implement detailed policies and procedures for the activation, deactivation, operation and administration of LMTs; and
- notify without delay their home regulator when activating or deactivating a LMT.

The Proposal implements the recommendations of the European Systemic Risk Board by granting sanction powers to competent authorities, who can force an AIFM or a UCITS to activate or deactivate suspension of redemptions and subscriptions or redemption gates or the LMT selected by the AIFM or UCITS. It is also proposed to empower ESMA to request competent authorities to force non-EU AIFMs marketing AIFs in the EU, EU AIFMs managing non-EU AIFs or UCITS management companies to do the same LMT activation or deactivation.

4. Delegations subject to increased substance requirements

4.1 Delegation model maintained with anti-letterbox provisions

Delegation consists of entrusting another entity with the performance of a function by an AIFM or UCITS management company (an investment fund manager or IFM). The Commission recognises that the existing delegation model under the AIFMD and UCITS regimes contributes to the success of the European fund industry but is proposing regulatory standards to ensure a sufficient level of investor protection and a consistent supervisory approach.

It is therefore proposed to continue allowing IFMs to delegate any type of function (including the core portfolio and risk management functions) and even more functions than they retain to the extent they do not become so-called “letterbox entities”.

However, IFMs must have sufficient human resources to perform the functions retained. It is proposed to provide expressly in the AIFMD and the UCITS Directive that, in line with the current administrative practice of national authorities:

- (a) the granting of an IFM licence is conditional upon at least two EU-resident senior managers being employed full time or committed full time to the conduct of the IFM’s business; and
- (b) at the time of the licence application, information must be provided to the national authority on (i) the suitability of (and time dedicated by) the persons effectively conducting the IFM’s business¹ and (ii) the human and technical resources used not only for carrying out functions but also for supervising delegates.

To align the AIFMD and UCITS regimes, UCITS management companies would be required to provide the objective reasons and justification for the entire delegation structure to their home regulator. UCITS prospectuses will have to disclose to investors the list of permitted delegations.

4.2 Delegation rules applicable to all functions and services delegated by an IFM

The Proposal clarifies that the delegation rules apply to the delegation of all functions by IFMs, including MiFID top-up services and, in relation to AIFMs, activities which are related to the assets of AIFs.

4.3 Notification to ESMA of substantial delegation of functions to third-country entities

If an IFM delegates more portfolio management or risk management than it retains to third-country entities, the competent authorities must notify ESMA on an annual basis.

The Proposal does not introduce substantial changes to the delegation rules, at least compared to the minimum substance requirements of IFMs in Luxembourg and Ireland. However, the new requirement to report delegations to third-country entities to ESMA raises concerns for the industry. ESMA would have to account at least every two years to the Commission, the European Parliament, the Council and Member States on the market practice regarding these delegations. This means that ESMA would be collecting and actively analysing information on delegations to third-country entities.

The industry fears that ESMA may suggest additional regulatory rules in the future as a result of such interventions on delegations outside of the EU, if for instance its findings are that substance requirements are insufficiently being met.

ESMA would also be expected to submit to the Commission draft regulatory technical standards on the content, form and procedure for the transmission of delegation notifications, with a view to ensuring consistency in the reporting.

At least every two years, ESMA would have to conduct a peer review on the supervisory practices regarding delegation by IFMs to entities located in third countries, with a focus on preventing the creation of letterbox entities.

¹The licence application must provide information on the role, title, seniority, reporting lines, responsibilities in and outside the IFM and the time allocated to each responsibility by the persons effectively conducting the IFM’s business.

5. Depositary

5.1 Clarification that Investor Central Securities Depositories (CSDs) are delegates of the depositary as opposed to Issuer CSDs

Under the existing AIFMD and UCITS Directive, CSDs are not considered delegates of the depositary. No distinction is made between issuer CSDs and investor CSDs. An issuer CSD provides for the safekeeping of the securities it issues, such as through the recording of securities in a book entry system or maintaining securities accounts while an investor CSD is the custodian of the securities issued by another CSD. In an opinion of June 2017, ESMA called for this distinction to ensure a level playing field between investor CSDs and other custodians as well as to enhance investor

protection. Indeed, where the fund's assets are safekept by an investor CSD, depositaries may be unable to conduct oversight monitoring if no delegation agreement provides for a stable flow of information on the portfolio movements between the CSD and the depositary. The Proposal suggests amendments to the AIFMD and UCITS Directive to bring investor CSDs into the custody chain as delegates of the depositary and to discharge the depositary from performing *ex-ante* due diligence on an issuer CSD.

5.2 Optional cross-border depositary services

The AIFMD currently provides that the depositary has to be established in the same Member State as the AIF. In small jurisdictions, the choice of depositaries may thus be limited while in fund domicile jurisdictions (mainly Luxembourg and Ireland) the range of choice is much larger. In its Consultation, the Commission suggested that the Proposal should introduce a depositary passport to improve the cross-border distribution of AIFs and to reduce concentration risk.

However, the industry feedback was that a depositary passport would have limited advantages (most banks have established branches) and adverse effects (the largest market players may increase their European reach).

Respondents suggested extending a transitional provision in the AIFMD, permitting a Member State to allow AIFs based in its territory to appoint a depositary in another Member State (the so-called Malta Clause). The Proposal retains the recommended extension of the Malta Clause.

According to the Proposal, the merits of a depositary passport are to be reassessed at the next review of the AIFMD, which would be five years after the entry into force of the new directive.

6. Update on the substitution of the FATF blacklist by official EU blacklists

The Proposal replaces references to the so-called "FATF blacklist", ie the list of Non-Cooperative Countries and Territories, by official lists maintained by the EU, namely the list of high risk countries² for AML purposes (the **EU Blacklist**).

The Commission wishes to strengthen the conditions for third countries wishing to access the EU market, in particular in respect of an EU AIFM marketing non-EU AIFs (article 36 of the AIFMD) or a non-EU AIFM marketing an AIF (article 42 of the AIFMD) under national private placement regimes (**NPPRs**).

Currently, the AIFMD requires non-EU AIFs marketed, and non-EU AIFMs marketing AIFs, under NPPRs to be domiciled in a country not blacklisted by FATF.

The Proposal provides now that these non-EU entities cannot be domiciled in a country listed on the EU Blacklist. In addition, all countries involved in the marketing of the non-EU AIF (ie the country of establishment of the non-EU AIF, the Member State of the AIFM and the Member States where the non-EU AIF will be marketed) must have signed a treaty compliant with article 26 of the OECD Model Tax Convention on exchange of information in tax matters – or any similar multilateral agreements – and non-EU AIFs must not be established in a country listed in the EU blacklist regarding non-cooperative jurisdictions for tax purposes³.

² This list includes Afghanistan, the Bahamas, Barbados, Botswana, Cambodia, Ghana, Iraq, Jamaica, Mauritius, Myanmar/Burma, Nicaragua, Pakistan, Panama, Syria, Trinidad and Tobago, Uganda, Vanuatu, Yemen and Zimbabwe.

³ This list is composed as of 5 October 2021 of: American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, the U.S. Virgin Islands, and Vanuatu.

7. Enhanced investor disclosures by AIFS

7.1 Additional disclosures to investors before investment

The Proposal provides for increased transparency towards investors, in particular:

- disclosure on the possibility and conditions relating to the use of LMTs;
- fees in connection with the operation of the AIF that will be “borne by the AIFM” or its affiliates. It is unclear whether

the Commission’s intention was actually to refer to fees to be “charged” by the AIFM or its affiliates, as it is difficult to see how the disclosure of fees borne by the AIFM would enhance transparency around the AIF’s expenses.

Such disclosures may be included in the offering document of the AIF.

7.2 Periodic disclosures to investors

It is proposed that AIFMs report to investors:

- on the portfolio composition of originated loan portfolios;
- on a quarterly basis, all direct and indirect fees and charges that were directly or indirectly charged or allocated to the AIF or to any of its investments (the reference to “any of its investments” is far reaching as the Commission is not limiting this reporting just to fees charged by the AIFM and/or service providers of the AIF); as well as
- on a quarterly basis, any entity (whether parent, subsidiary or special purpose vehicle) established in relation to the AIF’s investments by the AIFM, its staff or its (direct or indirect) affiliates.

8. Extended data reporting

The Commission opens up data reporting to potentially any types of instruments held by AIFs by removing the reference to “principal” markets or “main” categories of assets traded in article 24 of the AIFMD. ESMA is being called on to develop draft RTS on the content and format of this reporting as well as on the frequency and timing of it.

9. What's next?

9.1 Timing for final acts

Pursuant to the current Proposal, the amendments to the AIFMD and UCITS Directives become effective 20 days after publication in the Official Journal of the European Union.

It is difficult to predict when a political agreement will be reached between the European Parliament and Council and whether the Proposal will be substantially amended or not. It is expected that negotiations will last until at least the

second half of 2022, which would lead to the publication of a directive resulting from the Proposal in the Official Journal of the European Union in early 2023. Under the Proposal, Member States would have two years to implement the new directive. Depending on the timing of implementation, the rules could be effective by 2025.

9.2 Level 2 measures to follow

On the basis of the Proposal, the Commission is to entrust ESMA with substantial powers to develop draft Level 2 measures (draft regulatory technical standards or implementing technical standards, as the case may be) in relation to supervisory reporting, including the content and transmission of third- country delegation notifications and LMTs

(their characteristics, the criteria for their selection and use by IFMs and the situations in which Member States may require their activation or deactivation). The Commission would adopt the final act based on the draft Level 2 measures prepared by ESMA.

9.3 AIFMD 3: Next review five years from the entry into force of the new directive

The Proposal also foresees a new review clause. The Commission would have to initiate a review 60 months after the entry into force of the new directive. The review should assess:

– the impact on financial stability of the availability and activation of LMTs by AIFMs;

- the effectiveness of the anti-letterbox entities measures;
- the appropriateness of the requirements applicable to AIFMs managing loan-originating AIFs; and
- the appropriateness of a depositary passport.