

**Insights**

# **AIFMD II: AN EVOLUTION NOT A REVOLUTION AT ROUND 1**

25 November 2021

## **SUMMARY**

Today (25 November 2021) the European Commission (the **Commission**) released the results of its evaluation of the Alternative Investment Fund Managers Directive (**AIFMD**) which forms part of a **Capital Markets Union** legislative package. Whilst it finds that AIFMD has “generally worked well and largely achieved its objectives of establishing an effective supervisory framework for AIFMs, ensuring high levels of investor protection and facilitating the creation of the EU AIF market,” it proposes several target areas for improvement. The problem themes identified are: difficulties in monitoring and managing financial stability risks (including regulatory fragmentation in the loan origination sector); inefficiencies in managing investment funds (eg lack of streamlined supervisory reporting and lack of depositary services in smaller markets); and inadequate protection of fund investors due to member states’ differing interpretations of delegation rules.

We have set out below a summary of the findings and legislative proposals, including the main impacts on non-EU AIFMs.

Although industry in general had advocated a fine-tuning of some of the AIFMD measures without amending AIFMD itself, the Commission has chosen the latter approach in order to clarify the revised binding requirements. However, in our view the proposed changes in these measures generally comprise a measured and balanced package that are unlikely to create significant disruption in the industry. As changes to the Level 2 measures have not been announced at the same time as these Level 1 drafts, there is still scope for upset. A non-EU AIFM will be impacted in the main by:

- a tightening of the delegation rules (although robust investment management delegation arrangements set up as part of a UK fund manager’s Brexit planning should be able to continue intact) and as a consequence less flexibility on how third party appointments of non-core/ancillary activities are structured;

- increased investor disclosures (including on direct and indirect fees of the AIF or its investments) when marketing cross-border using the national private placement regimes (NPPR); and
- potentially problematic consequences of the ability for member state regulators to require an AIFM of an open-ended AIF to activate or deactivate a liquidity management tool.

There may be some frustration that the proposals do not pick up on some of the other issues previously raised that could have created opportunities for more market harmonisation, including cross-border marketing (there is no reference to the third country passport), concerns raised on an external valuer's liability under AIFMD and eliminating alleged barriers for sub-threshold AIFMs. Issues on improving AIFM access to retail investors form part of the proposed revisions to the ELTIF rules (published in parallel with the AIFMD proposals).

The amending Directive (2021/0376 (COD)) will enter into force 20 days following its publication in the Official Journal of the EU; EU member states will then have 24 months to implement.

It is not yet clear whether the UK will adopt similar changes to the onshored AIFMD regime.

### **Minimum stable EU substance within the AIFM**

A new condition of AIFM authorisation is that it has to have least two senior managers resident in the EU, being individuals who are either AIFM employees or committed to conduct the AIFM business, in each case on a full-time basis. As part of its authorisation application, an AIFM will need to provide detailed descriptions and overviews of the roles, responsibilities and reporting lines of those conducting the AIFM business, as well as a description of the human and technical resources to be used by the AIFM for monitoring and controlling any third party delegate.

For many EU AIFMs exercising robust supervision and substance, this is unlikely to cause significant change to current procedures. But it may cause some EU AIFMs and ManCos to need to revisit their structures, add further substance in the AIFM and put extra protocols around their delegation arrangements.

### **Third party delegation – a tightening of standards**

There are two fundamental changes to the AIFMD rules on delegation.

- First, the AIFMD provisions on delegation in Article 20 will apply to:
  - all Annex I AIFMD functions (expanded under the amending Directive to include originating loans and servicing securitisation special purpose entities), not just portfolio management and risk management; and
  - Article 6(4) ancillary services (e.g. collective portfolio management services, segregated mandates, investment advice and custody services under MiFID II), which are also to be

expanded to include benchmark administration and credit servicing permitted by EU laws.

The strict AIFMD delegation provisions, including effective monitoring of the delegate, will therefore apply to all AIFM activities and services not performed by the AIFM – including for instance fund administration and tax accounting. Currently some jurisdictions (such as the UK and Luxembourg) allow the ability to distinguish between a delegation of the AIFM's duties and a separate service provider appointment for additional management functions (i.e. administration, marketing and asset-related activities as set out in paragraph 2 of Annex 1 of the AIFMD). Other jurisdictions (such as Germany and Austria) apply a materiality test to be able to effectively outsource those functions where the AIFM itself does not retain full responsibility. This is an area where further guidance from the EU legislators would be useful. It will be necessary to monitor this item closely and assess whether changes will need to be made to ancillary and service provider appointments. As an AIFM must retain liability to the AIF for the failings of its delegates (which is not necessarily the case for a direct service provider appointment between the AIF and the service provider), AIFMs should consider what impact this has upon their risk exposures and insurance coverage.

Firms that conduct discretionary management through their AIFMs and engage in delegation should consider whether this model is sustainable under these new requirements, or whether they should be transferred to a MiFID licensed firm.

- Secondly, NCAs must notify ESMA (and provide various details) on an annual basis where an AIFMD delegates more portfolio or risk management function than it retains to entities in third countries.

Overall, these changes are preferable to the imposition of quantitative thresholds in the delegation rules (or even more stringent restrictions as recommended to the Commission by ESMA in its August 2020 letter). Yet they are clearly designed (without mention of Brexit) to impose requirements on the AIFM structure and operations to better monitor, manage and effectively supervise the uptick in delegation of portfolio management to non-EU entities, the use of 'white label AIFMs' and to avoid 'regulatory arbitrage' when structuring. It remains to be seen whether the updated Level 2 text, when published, places further constraints upon the delegation model. In an earlier circulated draft there was a new provision that only authorised asset managers could sub-delegate, which was thankfully removed from the final version.

## **Harmonisation of rules for AIFMs of loan-originating AIFs**

The proposed amendments introduce various operational requirements for managers of loan originating AIFs - to level the playing field, mitigate risk of liquidity mismatches and provide safeguards. Loan-originating/private debt funds are an important and growing source of financing; also expected to help facilitate the transition to investing in a sustainable green economy. Whilst

AIFMD contains requirements relating to AIFM's risk management processes and reporting, the new measures (summarised below) are specific and comprehensive. New transparency requirements on providing information on AIF loan portfolios are also to be fed into investor disclosures and reporting to national competent authorities (NCAs).

- AIFMs must have effective policies, procedures and processes in place (and review them at least annually) for granting loans, assessing credit risk and administering and monitoring its credit portfolio.
- AIFs must be closed-ended where the notional value of their loan origination is over 60% of its NAV – to avoid the impact of redemption pressures, particularly under stressed market conditions.
- Where the AIF lends to a single borrower that is a financial institution, MiFID investment firm, AIF or UCITS, the AIFM's lending is restricted to 20% of the AIF's capital (with flexibility for fund's raising or reducing capital or selling assets at the end of the AIF's life).
- An AIF has to retain 5% of the notional value of loans it has originated and subsequently sold on the secondary market (this does not apply where the AIF has purchased the loan on the secondary market, as it did not originate the loan). An AIF cannot lend to its AIFM or its staff, depositary or any of its delegates.

### **Improvement of cross-border access to depositary services**

The Commission's evaluation identified that some markets lack a competitive supply of depositary services. It is therefore allowing EU AIFs to deviate from the general rule, on a temporary basis pending further review, so as to be able to appoint a depositary located in another member state (in which case the depositary will be required to co-operate with all the relevant NCAs (of it, the AIF and AIFM, if different)). This should allow AIFMs to manage AIFs in smaller markets more efficiently.

The amending Directive also confirms that a Central Securities Depository (**CSD**) can be a delegate of a depositary and that no additional due diligence checks will be required as part of its appointment (as the CSD will have been sufficiently vetted on authorisation). This is to ensure that a CSD is part of the custody chain and that there is a stable information flow between the custodian of an AIF's assets and its depositary.

The introduction of a depositary passport was not deemed feasible, given the absence of harmonised EU securities and insolvency laws. However, its appropriateness is earmarked for review as part of the overall review of the amending Directive (within 5 years of coming into force).

### **Facilitate use of liquidity management tools (LMT) across the EU to better manage market stress**

In addition to any other LMT set out in the fund rules/constitutional documents, open-ended AIFs have to select at least one LMT from those set out in the revised Directive, and implement detailed policies and procedures to operate, administer, activate and deactivate such tools. The specific LMT form part of a new Annex V list and include redemption gates, notice periods and redemption fees. The Annex V list includes other LMT (such as redemption and subscription suspensions, swing pricing, anti-dilution levies, redemptions in kind and side pockets) that NCAs should also make available, as a minimum, to AIFMs of open-ended AIFs. Temporary suspension of redemption can only be applied in exceptional circumstances and where justified having regard to the interests of the AIF's investors. In addition, the amending Directive implements the European Systemic Risk Board's 2017 recommendations on liquidity and leverage risk in investment funds.

The AIFM will therefore still retain its discretion and flexibility to choose what most is appropriate for a specific AIF strategy, albeit that they have to choose at least one LMT from the specified list.

AIFMs must inform its home member state NCA when an LCT is used. NCAs can require an AIFM to activate or deactivate an LMT; and this is extended to non-EU AIFMs marketing in the EU.

## Other

We have set out below some additional points of interest in the amending Directive.

- **Additional Article 23 investor disclosures.** There are to include the below, and are likely to increase the reporting burden, but may reduce the need for some of the bespoke side letter provisions commonly requested.
  - A list of all direct and indirect fees and charges to be borne by the AIFM/its affiliates in its operation of the AIF.
  - On a quarterly basis, fees and charges charged or allocated to the AIF or any of its investments and of any subsidiary or entity established in relation to the AIF's investments by the AIFM, its staff or affiliates.
  - Details of an AIF's originated loan portfolio.
  - The AIF's LMT selected, along with the redemption rights in normal and exceptional circumstances.
- **ESMA regulatory and implementing technical standards to be developed** (forming part of the Level 2 measures). These are to include the below.
  - To standardise the delegation notification process.

- Criteria for the selection and use of LMT as well as the characteristics of those LMT set out in the amending Directive.
  - For situations when NCAs can require an AIFM to suspend units in the interest of investors or the public, or to activate or deactivate an LMT (as well as for a AIFM host member state to request the AIFM's home member state to do so).
  - In addition to the above, when a AIFM host member state can request the AIFM's home member state to take other supervisory action against a particular AIFM.
  - Streamlining NCA reporting and templates, taking into account other AIFM reporting requirements and removing limits on data that can be requested by NCAs.
- **AIFMD peer review and subsequent overall review.** ESMA will conduct a peer review analysis at least every 2 years to assess how rules on delegation are being applied, in particular measures to prevent the creation of letterbox entities. A review of the amended Directive will also take place within 5 years.
  - **Standards alignment.** References in AIFMD for third country entities to comply with FATF listings and OECD tax exchange agreement (eg in conditions of marketing and managing and on depositary appointments in third countries) are to be updated to align with current EU money laundering standards and requirements. This includes that non-EU AIFMs and non-EU AIFs cannot be located in a third country deemed un-cooperative in tax matters.

## Impact on UK AIFMs

UK AIFMs will not be directly impacted by the above proposals, unless the UK applies equivalent changes through the FCA Handbook and UK AIFM regulations. The UK government may also choose to prioritise other areas in any review – for instance, on the external valuer liability point. To the extent that the UK does not take an aligned approach, a UK manager could still be subject to the EU rules, as set out above (ie where it is marketing cross-border using the NPPRs, or acting as a delegate of an EU27 AIFM) or to set a baseline compliance standard across its global group. Alternatively, a UK AIFM may choose to opt into any new EU requirements, on a voluntary basis, for competitive/commercial advantage or in response to investor expectation.

## Context

The context of the amending Directive and supporting reports/other documents is a culmination of the Commission's wider review under Article 69 AIFMD (due to have started by July 2017). It follows the Commission's long-awaited Consultation on AIFMD that closed on 29 January 2021, as well as the January 2019 Commission report on the operation of AIFMD, produced by KPMG (although this found that "AIFMD has yet to prove itself" given the relatively short time since it came fully into

effect). The [output published](#) on 25 November 2021 takes into account the significant growth that the EU asset management industry has enjoyed since AIFMD came in to force on 21 July 2011.

## **Corresponding amendments to the UCITS Directive**

The changes to delegation, liquidity risk management, data reporting and regulatory treatment of custodians will also be applied to the UCITS Directive. Those amendments relating to loan origination and cross-border depository appointments will only apply to AIFMD.

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