

## Insights

# AIFMD II EUROPEAN PARLIAMENT DRAFT REPORT PROVIDES POSITIVE AMENDMENTS AND POINTS OF CLARITY

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On 18 May 2022 a [draft report](#) on 'AIFMD II' was published, containing proposals by a rapporteur presented to the ECON committee. It sets out a list of suggested amendments to the European Commission (the **Commission**)'s draft [amending Directive \(2021/0376 \(COD\)\)](#) (published on 25 November 2021 as part of its Capital Markets Union [action plan](#)). These will be debated (and further amendments can be proposed up to 27 June 2022), following which a majority vote of MEPs will determine which specific changes are to be passed on to the Committee Report stage, to be scrutinised by the Council of the EU. Although there is therefore still scope for change, this draft report (which involved discussions and feedback with regulators and stakeholders) provides encouraging momentum in the Commission's review of AIFMD. Overall, the proposals are to be welcomed. On delegation, they strike a balance between recognising the vital role delegation plays whilst creating the more robust framework the European legislators desire. On liquidity management, they clarify that the AIFM has primary responsibility for decisions on tools to deploy and amend specific provisions to reflect this. On loan originating AIFs, they generally provide more a workable and appropriate operational framework. It remains unclear whether or not the UK will adopt similar changes to the onshored AIFMD regime.

This briefing summarises the key changes to the original legislative proposals (which we set out in our [November 2021 briefing](#)). We also look at the recent [ESMA consultation](#) on standardising notifications to regulators for EU AIFMs marketing and managing funds cross-border in Europe. The AIFMD II review will be of greater impact across the fund industry, although the ESMA paper will involve AIFMs making practical changes to incorporate the new technical standards for their cross-border marketing and management notifications in order to ensure they submit the necessary documents and information to national competent authorities (**NCAs**) electronically and in the prescribed format.

## AIFMD II – changes proposed in the Rapporteur's draft report

### Recognition of third party delegation as an 'essential' AIFM activity

There are three important changes to the original proposals amending the AIFMD delegation provisions.

- On applying for authorisation, the AIFM will have to provide more detailed information on its delegated functions (in each case whether a full or partial delegation), on each delegate and on the 'other' Annex I functions it performs in addition to portfolio and risk management.
- The amendments suggest removing the provision for NCAs to notify ESMA on an annual basis where an AIFM delegates more portfolio or risk management function than it retains to entities in third countries. Instead, AIFMs are to provide various information as part of their annual reporting to regulators under Article 24 (including on the functions delegated or sub-delegated, whether these are full or partial and the periodic due diligence measures carried out by the AIFM overseeing the delegate).
- Although the strict AIFMD delegation provisions proposed remain (ie that these will apply to all AIFM activities and services and Article 6(4) ancillary services, not just portfolio and risk management), there is a suggested carve out for functions of distribution agents who are acting on their own behalves (ie as principal) - these will not be considered delegation. Conversely, a distributor acting as agent for the AIFM would be considered a delegate. It would have been even more helpful to have expanded this amendment beyond marketing to other additional management functions such as administration and asset-related activities.

### **Clarity that the AIFM has primary responsibility for decisions on liquidity management tools (LMTs)**

We would note three proposed areas of improvements.

- The proposed new Annex V list of LMTs that open-ended AIFs have to select at least one of (and implement detailed policies and procedures to operate, administer, activate and deactivate such tools) is expanded to include swing pricing, anti-dilution levies, redemptions in kind and side pockets – in addition to the original list of redemption gates, notice periods and redemption fees.
- Rather than the original blanket requirement proposed, AIFMs only have to inform their home member state NCA when certain LMTs are used (suspension of redemptions/subscriptions, redemption gates, notice periods and/or redemption fees) and in times of liquidity stress.
- The ability of NCAs to require an AIFM to activate or deactivate an LMT is proposed to be limited to exceptional circumstances and after consulting with the AIFM. Importantly for those operating outside Europe, this mechanic no longer also captures non-EU AIFMs marketing in the EU.

Given that the AIFM is acknowledged to have primary responsibility for liquidity risk management, the amendments provide that ESMA should allow time for the market to adapt before it applies the

technical standards on selection and use of LMTs that it is due to develop (in particular for existing AIFs).

### **More workable proposals on harmonising rules for AIFMs of loan originating AIFs**

The draft report emphasises that loan-originating/private debt funds are an important and growing source of financing. It also helpfully states that AIFMD is not about creating specific product rules and introduces a definition of 'loan origination' ('the granting of loans by an AIF as the original lender'). Whilst some fine-tuning would be helpful, the four key suggested amendments set out below are likely to be endorsed by the industry and reflect stakeholder feedback, moving away from unnecessary risk retention and disproportionate restrictions originally proposed to be placed on open-ended AIFs in this sector. Less welcome is likely to be a new proposed amendment that, in addition to its AIFM or its staff, depositary or any of its delegates, that an AIF cannot lend to group entities of the AIFM or to delegates of its depositary. This will inhibit lending flexibility in AIFM group structures.

- An AIF (whether or not it is providing loans or investing in illiquid assets) only has to be structured as closed-ended if the AIFM cannot demonstrate to its NCA its AIF's liquidity robustness (and ESMA will adopt regulatory technical standards on criteria for this). Reference to AIFs being closed-ended where the notional value of their loan origination is over 60% of its NAV has been removed.
- Removal of the provision that an AIF has to retain 5% of the notional value of loans it has originated and subsequently sold on the secondary market (except where the AIF has purchased the loan on the secondary market, as it did not originate the loan). Instead, a new prohibition that AIFs should not follow an originate-to-distribute investment strategy, being an investment strategy under which loans are originated with the sole purpose of selling them (whilst preserving the right of AIFs to trade loans they otherwise originate on the secondary market).
- A carve out to the requirement for an AIFM to 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, so that this does not apply for shareholder loans (ie granted by an AIF to an undertaking where the AIF holds directly or indirectly at least 5% of the capital or voting rights and where the loan cannot be sold independently to third parties) that do not exceed 150% of the AIF NAV.
- Clarification that, 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, this includes commitments or overall subscriptions (and with flexibility for fund's raising or reducing capital or selling assets at the end of the AIF's life). Therefore potentially extending the amount available to be lent.

## Other

There are a few other additional points of interest in the proposed amendments.

- Going further than the original proposal which earmarked the future introduction of a depositary passport, the draft report proposes that the Commission carries out a comprehensive study on its introduction within 24 months of the amending Directive coming into force.
- An expanded definition of professional investor to include (in addition to MiFID II 'professional client') investors with at least €100,000 commitment and who have signed a risk warning and any member of the senior management team or employee of the manager or an affiliate of it who has sufficient knowledge of the AIF concerned. This is a significant suggested revision, the effect of which is to expand the type of investor an AIF could be marketed to. A PRIIPs KID may still be required for the new sub-categories of investors in this definition, however, unless it is applied more broadly.
- Article 6(4) ancillary services (eg collective portfolio management services, segregated mandates, investment advice and custody services under MiFID II), are to be expanded to include any other ancillary investment service unregulated by MiFID II that represents a continuation of services already undertaken by the AIFM or a use of internal competences that does not create unmanageable conflicts. This builds on the proposed expansions in the original draft (to include benchmark administration and credit servicing permitted by EU laws in the list of non-core services) and hence also fall within the proposed AIFMD strict delegation provisions (as set out in our [November 2021 briefing](#)). This is an area of regulatory risk and where further guidance from the EU legislators would be useful.
- The draft report proposes broadening regulatory reporting obligations under Article 24 to include "other relevant economic and accounting information" in general and adding a specific obligation (in addition to those set out above on delegation) to state the total amount of leverage of the NAV employed by the AIF. In contrast, some of the new Article 23 investor disclosures originally proposed are proposed to be reduced. For instance, removing the requirement to provide all fees and charges to be borne by the AIFM/its affiliates in its operation of the AIF and only capturing fees and charges that are directly or indirectly charged to the AIF and on an annual basis (rather than quarterly and to include fees charge or allocated to the AIF or any of its investments).
- ESMA will conduct a peer review analysis at least 12 months before the review of the amended Directive (to take place within 5 years) to assess how rules on delegation are being applied, in particular measures to prevent the creation of letterbox entities. This allows a bit longer for the new rules to bed in than the 2-year frequency in the original draft.

EU AIFMs managing and marketing EU AIFs in Europe have to notify the NCAs of their national and cross-border marketing and management activities. On 17 May 2022 ESMA opted to launch a consultation to develop technical standards (set out in draft regulations) to determine the form, content and manner of the information EU AIFMs have to provide as part of this process. The purpose of these new provisions is to ensure consistent notifications for cross-border activities, avoid any discrepancies in national approaches and to facilitate the exchange of information between regulators. Although not explicit, this initiative may help facilitate the introduction of third country passports provided for in AIFMD.

The draft regulations build on the generic requirements in AIFMD and set out precise information and specifics to be submitted to NCAs for certain notifications. For an EU AIFM managing an EU AIF and providing any non-core service in other member states, this includes:

- details of investment management activities and any non-core services;
- description of the AIFM strategy in its host member state, including categories of targeted clients and investors and how the AIFM will deal with them;
- details of any delegation arrangements for activities carried out in the host member state (and of systems and controls that will be put in place for third party delegation arrangements); and
- where an AIFM uses a branch: contact details of a designated person within the branch, its managers and how the branch contributes to the AIFM/group strategy; details of functional, geographical and legal reporting lines; its reporting to the head office; risk management processes at branch level; details of individuals performing key functions; any delegation arrangements and forecast statements for profit and loss and cashflow over an initial 36 month period.

In addition, there are template notification letters for an EU AIFM marketing an EU AIF to professional investors in its home member state and other member states, and for the cross-border management of AIFs. For marketing notifications, these templates supplement the AIFMD Annex III and IV requirements. EU AIFMs are to submit the tailored information by email (or such other electronic communication system put in place) to NCAs. The letters are to be sent to the home member state only. There is also a duty to communicate to the NCAs any changes to information previously sent. Given that there is scope for regulators to be more hands on with enforcement and investigations in this area, firms should ensure that their systems are in place to monitor and flag any necessary updates.

The consultation covers EU UCITS as well as EU AIFs/AIFMs. It closes on 9 September 2022 and ESMA intends to publish a final report by early 2023. Once finalised and adopted, the technical standards set out in the regulations will enter into force and apply in short order (20 days following their publication in the Official Journal of the EU).

Those marketing under the national private placement regimes (NPPRs) are out of scope. However, once implemented, it is still worth checking and confirming the position on a country-by-country basis; we have in mind the fact that some member states (Luxembourg and Germany for instance) have extended their implementation of the cross-border distribution of collective investment funds legislative package (ie on pre-marketing) to bring non-EU AIFMs marketing under the Article 42 NPPRs within scope. It may be that some NCAs follow the more prescriptive notification approach on an adaptive basis where possible, and apply the technical standards across the board.

Please feel free to call any of the BCLP Funds & Investment Management team or your usual BCLP contact if you would like to discuss any of the issues raised in this briefing in more detail, including how they may apply to your specific fund structures, business and planning.

## RELATED PRACTICE AREAS

- Corporate Real Estate and Funds

## MEET THE TEAM



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