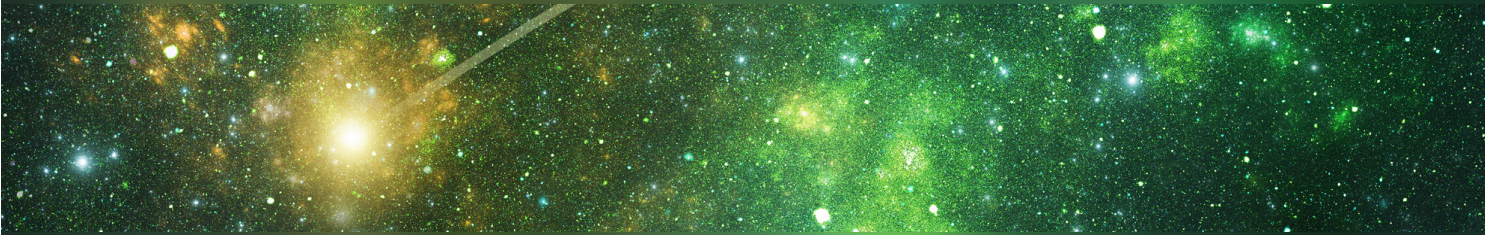


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**C H A N C E**



**EU AIFMD: THE AIFMD2 LEGISLATIVE PROPOSAL**

## EU AIFMD: THE AIFMD2 LEGISLATIVE PROPOSAL

### Speed read

On 25 November 2021 the European Commission (the “**Commission**”) published its **legislative proposal** for AIFMD2 (the “**proposal**”). Here are our key takeaways from the proposal:

- **Delegation:** the proposed amendments to the AIFMD’s delegation provisions are lighter-touch than many expected. While the Commission explored the introduction of additional qualitative and quantitative caps on delegation during its AIFMD review, no such caps have ultimately been proposed. The changes in the sphere of delegation largely amount to extended data collection by competent authorities, such as the introduction of a requirement for reports to be sent to ESMA where an AIFM delegates ‘more’ portfolio or risk management functions to an entity located in a third country than the AIFM retains.
- **Lending activities:** by contrast to delegation, the proposal goes further than many expected with respect to loan origination. The proposal adds ‘originating loans’ to the list of activities that an AIFM may perform, with the Commission’s explanatory text adding that ‘this means AIFs could extend loans anywhere in the Union, including cross-border’. Skin-in-the-game, concentration measures and conflicts measures are also introduced.
- **Liquidity risk management:** as anticipated, additional liquidity risk management provisions are proposed, including a list of liquidity risk management tools which national competent authorities must make available to AIFMs and from which AIFMs that manage open-ended AIFs must select at least one.
- **Marketing:** a seemingly innocuous, but potentially significant, change is to state that AIFMs may not market AIFs into the EU if the AIFM and/or the AIF is located in a non-cooperative (as deemed by the European Council) tax jurisdiction or high-risk AML jurisdiction (under the EU’s AML directive<sup>1</sup>, as opposed to under the FATF’s list). Popular fund management locations have been included, and have been mooted for inclusion, upon these lists although at present no such jurisdictions are listed.
- **Disclosure and reporting:** additions are made to the matters that must be disclosed to investors, such as lists of fees and charges, and ESMA is tasked with drafting a revised Annex IV reporting template.
- **Depositaries:** the proposal makes a significant change which widens the scope of the entities that are considered delegates of depositaries to include central securities depositaries (CSDs).
- **UCITS:** finally, the proposal also includes amendments to the UCITS Directive<sup>2</sup>, the predominant result of which is to harmonise the UCITS framework with AIFMD2 in the areas of delegation, liquidity management and supervisory reporting.

The proposal will now move to the next stage in the EU legislative process, in which it is considered and potentially amended by the European Parliament and European Council prior to its ultimate adoption.



1. Directive (EU) 2015/849

2. Directive 2009/65/EC

## In depth

### What is the AIFMD?

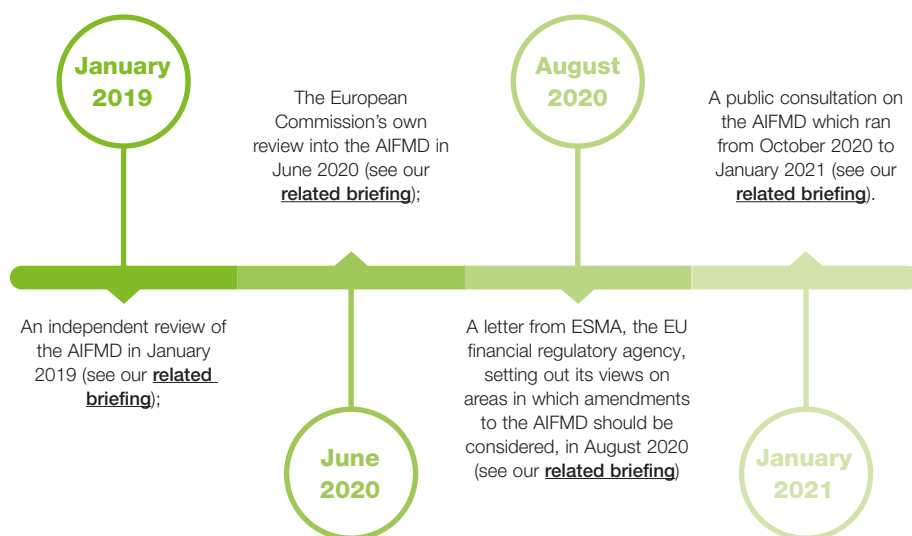
The Alternative Investment Fund Managers Directive<sup>3</sup> (the “**AIFMD**”) is an EU directive that governs the way in which an array of fund managers, from private equity and hedge fund managers to certain retail fund managers, operate, manage and market their funds. It entered into force on 21 July 2011. While many of its provisions apply only to EU alternative investment fund managers (“**AIFMs**”), certain provisions also apply to non-EU AIFMs that manage EU alternative investment funds (“**AIFs**”) or that market EU or non-EU AIFs into the EU.

### What is AIFMD2?

The text of the AIFMD requires the European Commission to review the AIFMD and to propose amendments to it, if appropriate. The term AIFMD2 refers to the future, amended version of the AIFMD, the legislative proposal for which has just been published.

### What has been the story so far?

The European Commission’s review of the AIFMD has taken a number of years to complete. The key milestones in the review process have been the publication of:



The publication of the proposal represents the culmination of this review process.

### What key changes does AIFMD2 make?

The proposal takes the form of draft amendments to the AIFMD itself but not to the regulations that accompany the AIFMD and form part of the overall AIFMD package. Proposed amendments to these regulations may, therefore, follow at a later date. As the proposed changes to the AIFMD will be made through a directive, each EU Member State will need to implement the changes and sufficient time will need to be afforded to the Member States to enable them to do so.

3. Directive 2011/61/EU

The draft text proposes changes to the AIFMD in the following key areas:

### **Delegation**

- The proposal introduces a new requirement for competent authorities to notify ESMA where an AIFM delegates more portfolio management or risk management functions to entities located in third countries than the AIFM retains. ESMA is empowered to draft regulatory technical standards to determine the content of these notifications.
- The proposal introduces requirements for ESMA to: (i) report to the European Parliament, Council and Commission at least every two years on market practices regarding delegation to entities located in third countries; and (ii) conduct a peer review of the supervisory activities of competent authorities in the area of delegation, including the measures taken to prevent the AIFMs from becoming letter-box entities.
- The proposal also clarifies that the existing requirement for AIFMs to notify the competent authorities of their home member state before delegation to third parties becomes effective applies when the functions listed in Annex I of the AIFMD or the services listed in Article 6(4) of the AIFMD are delegated.

### **Lending activities**

- The proposal introduces a new requirement for AIFMs to implement annually-reviewed policies, procedures and processes for credit granting, credit risk assessment and the administration and monitoring of their credit portfolio.
- The proposal prohibits AIFs from providing loans that exceed 20% of the AIF's capital to a single borrower that is a financial institution or collective investment undertaking, and prohibits AIFs from lending to their AIFM or its staff, their depositary or an entity to which their AIFM has delegated functions.
- The proposal introduces a new requirement for AIFs to retain 5% of the notional value of the loans that they originate and subsequently sell on the secondary market.

### **Liquidity risk management**

- The proposal introduces a new requirement for AIFs to be structured as closed-ended funds if the notional value of the loans that they originate exceeds 60% of their net asset value.
- The proposal also introduces new requirements for AIFMs that manage open-ended AIFs to select at least one appropriate liquidity management tool from the list set out in a new annex to AIFMD2 and to implement policies and procedures regarding the use of that tool.
- The proposal confirms that AIFMs managing open-ended AIFs may, in the interests of investors, temporarily suspend the purchase or redemption of AIF units in exceptional circumstances.

### **Marketing by non-EU AIFMs and/or of non-EU AIFs**

- The proposal amends the conditions for marketing into the EU where there is a third country nexus (i.e. where either the AIF, the AIFM or both are outside the EU) in two key respects:
  - the prohibition on marketing where the AIFM/AIF is located in a third country that is listed as a non-cooperative country and territory by FATF is replaced by a prohibition on marketing if the AIFM/AIF is located in a country that is identified as a high-risk third country pursuant to the AML Directive.

- an additional requirement is included for the AIFM/AIF not to be located in a country mentioned in Annex I to the Council conclusions of 2020 on the revised EU list on non-cooperative jurisdictions for tax purposes.

#### **Disclosure to investors**

- Two amendments are made to the pre-contractual disclosures that must be provided to investors under Article 23 of the AIFMD. These are the introduction of a requirement to disclose:
  - the possibility and conditions for using the liquidity management tools that the AIFM has selected; and
  - a list of fees and charges that will be applied in connection with the operation of the AIF and that will be borne by the AIFM or its affiliates.
- Three amendments are made to the periodic reporting that must be made to investors. These are the introduction of requirements to disclose:
  - the AIF's originated loan portfolio (the Commission states that, under this change, AIFMs would be required to disclose to investors 'the portfolio composition of originated loans');
  - quarterly, all direct and indirect fees and charges that were charged or allocated to the AIF or its investments; and
  - quarterly, the establishment by the AIFM, its staff or its direct or indirect affiliates of any parent company, subsidiary or special purpose entity in relation to the AIF's investments.

#### **Regulatory reporting**

- The proposal removes certain limitations on data reporting that existed under the AIFMD (for example, AIFMs will now be required to report on the 'markets' in which they trade as opposed to the 'principal markets'), which may result in the need for AIFMs to provide more expansive regulatory reporting.
- The proposal requires ESMA to draft new regulatory technical standards and regulatory implementing standards to replace the current supervisory reporting template laid down in Annex IV of the AIFMD.

#### **Additional functions that an AIFM may perform and services that an AIFM may provide**

- The proposal adds two functions to the list of functions that an AIFM may currently perform. These are loan origination and the servicing of securitisation special purpose entities.
- The proposal also adds two additional services to the list of services that an AIFM may provide. These are benchmark administration and credit servicing (in accordance with the new EU directive on non-performing loans – see our briefing on that directive [here](#)).





### **Content of applications for authorisation as an AIFM and conditions for authorisation as an AIFM**

- The proposal increases the level of detail that must be provided in applications by managers for authorisation as an AIFM, requiring increased detail in relation to the persons who will effectively conduct the business of the AIFM and the human and technical resources that will be involved in the organisational structure and in the monitoring and control of delegates.
- A previous requirement for the conduct of an AIFM's business to be decided by at least two persons is now supplemented to state that those persons must be resident in the EU and must be employed full-time or committed full-time to the conduct of the AIFM's business.

### **Depositaries**

- At present, the depositary of an EU AIF must be established (incorporated or operating through a branch) in the home Member State of the AIF. It is proposed that the EU AIF's competent authority may allow an entity established in a different Member State to be appointed as depositary (provided that such entity is an EU credit institution).
- Currently the AIFMD does not permit depositaries to be appointed for non-EU AIFs if they are located in a third country that is listed as a non-cooperative country and territory by the Financial Action Task Force (FATF). The proposal replaces this requirement with a requirement for the depositary not to be located in a country that is identified as a high-risk third country pursuant to the AML Directive.
- The proposal introduces a new requirement for the depositary of a non-EU AIF not to be located in a country mentioned in Annex I to the Council conclusions of 2020 on the revised EU list on non-cooperative jurisdictions for tax purposes.
- At present, use by a depositary of a CSD is not regarded as delegation (hence various requirements regarding due diligence, terms to be imposed on delegates and liability for delegates do not apply to use of a CSD). In a major change, it is proposed that use of any CSD will be regarded as delegation, the only exception being where the CSD is an issuer CSD. As a result, a depositary would need to comply with all provisions that apply to delegation, such as due diligence, imposing required terms, and accepting a very high level of liability, when holding securities through a CSD unless that CSD is acting as an issuer CSD. An issuer CSD is a CSD that provides a notary service or central maintenance service in relation to a securities issue.

### **What isn't included in AIFMD2?**

- *A concept of semi-professional investors* – although many market participants were in favour of introducing a concept of semi-professional investors in order to widen the scope of the marketing passport (which permits marketing to professional investors only), the Commission has not taken this point forwards in its proposals.
- *Any clarifications or restrictions on reverse solicitation* – the market has anticipated for some time that the EU may introduce greater harmonisation (and restrictions) around the concept of reverse solicitation but the Commission has not proposed to do so via AIFMD2. This is most likely because the Commission has yet to publish its report on reverse solicitation, due on 2 August 2021 under the Cross-Border Distribution of Funds Regulation (Regulation (EU) 2019/1156).

- *A depositary passport* – the proposal requires the Commission to consider, 60 months after the entry into force of AIFMD2, the appropriateness of introducing a depositary passport, as opposed to attempting to use AIFMD2 to introduce this passport.
- *Changes to the dormant third country passport provisions* - the AIFMD contains provisions that would permit a marketing passport to be used by both EU and non-EU AIFMs and AIFs. While EU AIFMs of EU AIFs are able to use the marketing passport, it has never been ‘switched on’ for non-EU AIFMs or for EU AIFMs of non-EU AIFs. Although ESMA initially began to conduct the assessments of third countries required in order to ‘switch on’ the passport for these AIFMs, progress stalled. There remains no confirmed timeframe for the ‘switching on’ of the passport for non-EU AIFMs and EU AIFMs of non-EU AIFs. The proposal makes no change to the availability of the AIFMD’s third country passporting provisions, with the result that the dormant third country passport would continue to live on in the text of AIFMD2.

#### **Is this relevant to fund managers outside the EU?**

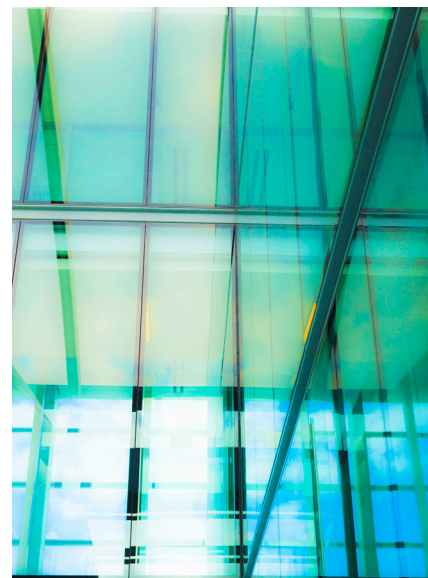
In a nutshell, yes. The key points of which non-EU managers should be aware are:

- *Tweaks to existing requirements* - under the AIFMD, if a non-EU AIFM wishes to market an AIF into the EU, it must comply with certain sections of the AIFMD. These are Articles 22 (Annual report), 23 (Disclosure to investors) and 24 (Reporting obligations to competent authorities). The proposal retains this position but, as noted above, tweaks the investor disclosure and regulatory reporting requirements. These changes will apply to disclosures and reporting by non-EU AIFMs.
- *New conditions for non-EU entities* - as noted above, the proposal introduces new conditions that non-EU AIFMs and non-EU AIFs must not be located in jurisdictions that are identified by the EU as high-risk third countries for money-laundering purposes or as non-cooperative jurisdictions for tax purposes if they wish to market into the EU.
- *Delegation requirements* - groups with non-EU entities in the structure will need to consider whether any issues are posed by the introduction of the new prohibition on sub-delegation by delegates that are not authorised or registered for the purposes of asset management.

#### **What about the UCITS Directive?**

The proposal also proposes changes to the UCITS Directive, the purpose of which the Commission states is to better align the AIFMD and UCITS Directive requirements. The proposed amendments to the UCITS Directive broadly reflect the proposed amendments to the AIFMD, and therefore include:

- an increased level of detail that must be provided in applications by a manager for authorisation as a UCITS manager;
- the introduction of a requirement for a UCITS manager to be able to justify its delegation structure on objective reasons (which was already a requirement for AIFMs under the AIFMD) in addition to other changes to the delegation provisions to reflect those proposed under AIFMD2;



- changes to the liquidity management provisions which, again, are largely reflective of those proposed under AIFMD2; and
- changes to introduce a periodic supervisory reporting obligation, in line with that contained in AIFMD2.

### **What happens next?**

The proposal will now be considered by the European Council and European Parliament. This is likely to result in amendments to the proposal. The consideration is expected to last until at least mid-2022. Once an agreement is reached on the text of AIFMD2, it will be adopted as law, following which there will likely be an implementation period (usually approximately two years) before the provisions enter into application.

### **What do firms need to do now?**

Firms should:

- continue to track the progress of AIFMD2, monitoring for changes to the legislative proposal;
- create an impact assessment based on the current legislative proposal for AIFMD2;
- use the impact assessment to identify areas in which changes to the AIFM's policies, procedures and activities may be needed;
- explore potential ways to satisfy the required changes; and
- determine the timeframe that would be needed to implement those changes.

This will ensure that firms are well-prepared to implement their regulatory change projects when AIFMD2 is finalised and its provision begin to apply.



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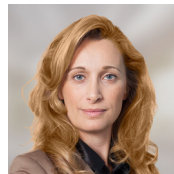
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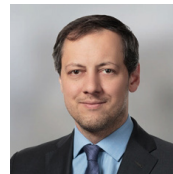
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