Baker McKenzie.

Client Alert

May 2023

European Union: AIFMD II state of play - preparing for change

In brief

On 25 November 2021, the European Commission published its long-awaited proposals to amend the Alternative Investment Fund Managers Directive (AIFMD), along with changes proposed to the UCITS Directive and ELTIF Regulation (AIFMD II). The Commission's proposals follow ESMA's August 2020 letter of recommendations for changes that could be made to the AIFMD framework (for more detail on those recommendations, please see our earlier blog post). Tripartite negotiations on AIFMD II are ongoing, following agreement by the Council of the EU on its general approach in June 2022, and adoption by the European Parliament's Economic and Monetary Affairs Committee (ECON) of its negotiating position in January 2023. In this alert we aim to help prepare the industry for the forthcoming changes, focusing on some of the Commission's key original proposals for amendments to the AIFMD and how the current positions taken by the Council and ECON diverge from the Commission's proposals.

The changes set out in AIFMD II relate to, among other topics:

- delegation arrangements and substance requirements;
- liquidity risk management;
- loan origination activities;
- fund marketing;
- depositary and custody services; and
- data collection and reporting.

Subject to the outcome of the negotiations and finalisation, we expect that AIFMD II may enter into force in late 2023. EU Member States will then have 24 months to transpose the legislation and new requirements into national legislation, with legislative changes expected to take effect in late 2025.

Contents

Delegation and substance requirements

In its letter, ESMA highlighted the potential for increased operational and supervisory risks arising from extensive use of delegation arrangements, in particular where collective portfolio management is delegated in large part or in its entirety to non-EU entities – arrangements which have taken on renewed importance following Brexit. In response to these risks, ESMA had recommended legislative clarifications under both the AIFMD and UCITS Directive on the maximum extent of delegation to ensure both supervisory convergence and that authorised AIFMs and UCITS management companies maintain sufficient substance in the EU, possibly including quantitative criteria or a list of core or critical functions that must always be performed internally and may not be delegated to third parties.

ESMA also recommended that legislative amendments should ensure that the management of AIFs and UCITS is subject to the regulatory standards set out in the AIFMD and UCITS Directive frameworks, irrespective of the regulatory license or location of the delegate. ESMA further raised concerns about seconded staff, particularly where those seconded staff remain in their usual offices but do not undertake work on a delegated basis.

To the industry's relief, the European Commission decided not to take forward ESMA's most onerous recommendations, including the extension of AIFMD requirements to delegates regardless of location, and a cap on the maximum extent of delegation – indeed, the Commission explicitly recognised that an AIFM may delegate "more portfolio management, or risk management functions of the AIF, than it manages itself to entities located in third countries", and there is no proposed minimum proportion of activities to be retained by the AIFM in-house. However, the Commission has proposed a number of other significant and burdensome amendments relating to delegation, including the following requirements:

- When applying for authorisation, prospective AIFMs must provide national competent authorities (NCAs) with information on arrangements made for the delegation and sub-delegation to third parties and a detailed description of the "human and technical resources" to be used for monitoring and controlling the delegates.
- NCAs must not grant authorisation unless the business of the AIFM is conducted by at least two natural persons who are either employed full-time by that AIFM or who are committed full-time to conduct the business of that AIFM and who are resident in the EU.
- NCAs must notify ESMA on an annual basis of all delegation arrangements where an AIFM delegates more portfolio management or risk management functions to entities located in third countries than it retains, including detailed information mapping the delegation practices (deemed "delegation notifications").

The Commission has also proposed a set of regular reports and reviews on the delegation regime, suggesting that further tightening could be proposed in due course:

- ESMA must issue a report at least every two years analysing market practices regarding delegation to entities located in third countries and compliance with AIFMD delegation provisions, intended to address divergent practices among Member States. ESMA must also conduct a peer review every two years on delegation practices, focusing on preventing the creation of letter-box entities.
- Five years after entry into force of the amended AIFMD, the Commission must review the delegation regime with a view to proposing the necessary amendments to preclude the formation of letter-box entities.

The Commission has proposed to extend application of the AIFMD delegation requirements to cover delegation of Article 6(4) ancillary "top up" services (which will be broadened to include benchmark administration and credit servicing), as well as all Annex I functions (which will be expanded to include loan origination and the servicing of securitisation special purpose entities). This extension has been preserved in both the Council and ECON positions.

Delegation: Council and ECON positions

On substance, the Council and ECON have not made changes to the Commission's proposals, nor have they proposed additional restrictions. However, the proposal to require delegation notifications has been removed by both the Council and ECON in their negotiating positions, which means that it is unlikely to survive in AIFMD II once finalised.

While both the Council and ECON have preserved the Commission's five-year review of the delegation regime, the Commission's proposals on delegation reports have been modified by both the Council and ECON, with a single report on market practices due before the five-year review. The peer review has also been removed from the Council's position entirely.

Both the Council and ECON have preserved the Commission's extension of delegation requirements to cover ancillary "top up" services. However, both carve out from delegation marketing through distributors under the revised Markets in Financial Instruments Directive (MiFID II) or through insurance-based investment products in accordance with the Insurance Distribution Directive - where the marketing function is performed by one or several distributors acting on their own behalf and not on behalf of the AIFM, this should not be considered a delegation and would therefore not be subject to the delegation requirements irrespective of any distribution agreement between the AIFM and the distributor.

Further, the Commission has proposed to harmonise the delegation requirements in the UCITS Directive with those proposed for the AIFMD regime, which is preserved in the Council and ECON negotiating positions. Historically, the text of the UCITS Directive has been viewed as somewhat more flexible and less technical on the issue of delegation, so UCITS Management Companies will need to review the final rules closely and consider whether any additional controls are required to be put in place as a result.

The proposals on delegation have their genesis in Brexit, and concerns expressed by ESMA in particular around the level of portfolio management activities being delegated outside of EU competent authorities' supervisory remit, given that London remains a common jurisdiction to establish sub-managers to both AIFMs and UCITS Management Companies. However, since the new requirements on delegation will have a knock-on effect on other third countries, including the U.S., the Commission's original proposals caused a fair amount of consternation across the market. In a welcome development for the industry, while both the Council and ECON have included additional reporting requirements relating to delegation in their positions, neither have included substantive restrictions, and both have removed the Commission's draft proposals for "delegation notification" requirements. The manner in which these reporting requirements are implemented in practice will be observed closely by many, however, given the renewed potential for regulators to question whether EU managers have sufficient substance or are simply operating as "letter box entities".

Liquidity risk management

In line with similar recommendations made by the ESRB and ESMA, the European Commission has proposed a harmonised minimum list of liquidity management tools (LMTs) for managers to use where required and for regulators to apply. AIFMs managing open-ended AIFs may, in the interest of AIF investors, temporarily suspend the repurchase or redemption of the AIF units, "in exceptional cases where circumstances so require and where suspension is justified". AIFMs of open ended-AIFs must also select at least one appropriate LMT from a list proposed in new Annex V, including redemption gates, notice periods and redemption fees. AIFMs are required to implement detailed policies and procedures for the activation and deactivation of any LMTs, and notification and disclosure requirements also apply.

Interestingly, under the Commission's proposals ESMA is empowered to require AIFMs to activate or deactivate a LMT "in the interest of investors or of the public" – though it is unclear how that trigger would be determined.

Further, and more controversially, in an extraterritorial extension of regulatory remit the Commission has proposed to empower ESMA to require non-EU AIFMs marketing AIFs into the EU or EU AIFMs managing non-EU AIFs to activate or deactivate a LMT – though notably without the limiting language "in the interest of investors or of the public". It is, however, unclear how ESMA would purport to intervene in third country national laws governing fund establishment in order to force this choice upon those AIFMs.

The Commission will review the impact on financial stability of the availability and activation of LMTs by AIFMs five years after entry into force of the amendments.

LMTs: Council and ECON positions

The Council and ECON positions on liquidity risk management diverge from the Commission's proposals in several respects:

- The Council and ECON have not made major changes to the LMT provisions, although they propose that the AIFM must select two appropriate LMTs rather than one (unless the AIF is a money market fund).
- ECON further narrows ESMA's power to require LMT activation or deactivation by adding additional conditions, permitting ESMA to act only " in the interest of investors, in exceptional circumstances and after consulting the AIFM, and if there are reasonable and balanced investor protection or financial stability risks that necessitate this requirement". The Council omits the provisions on this power entirely.
- ECON preserves ESMA's power to act extraterritorially without changes, but the Council omits these provisions entirely.

Loan origination

In 2016, ESMA issued an opinion recommending a substantial new harmonised framework on loan origination by funds, in order to reduce regulatory arbitrage and coordinate bespoke regimes among member states (resulting in funds operating cross-border needing to comply with different requirements for their loan origination activities). ESMA's opinion contained recommendations on (i) an authorisation gateway for loan originating funds and managers; (ii) limiting loan origination to closed-ended vehicles; (iii) restricting access to retail investors and/or introducing new rules for investor protection; and (iv) organisational and prudential requirements for loan-originating funds (including leverage, liquidity, stress testing, reporting, diversification, and so on).

The Commission has opted not to introduce a fully-fledged harmonised loan origination framework for AIFs. Instead, the Commission has proposed that:

- AIFMs managing loan-originating AIFs must implement effective policies, procedures and processes for the granting of loans. In doing so, they must assess credit risk, and administer and monitor their credit portfolios, which should be reviewed periodically.
- To reduce financial stability risk and conflicts of interest, lending is prohibited to:
  - a single borrower, when this borrower is a financial institution or a collective investment undertaking, and the loan exceeds 20% of the AIF's capital. This limitation must apply at no later than half the life of the AIF, although NCAs may approve an extension of up to one year; and
  - the AIFM or its staff, the depositary or a delegate of the AIFM.
- To maintain the credit quality of loans originated by AIFs, AIFs must retain on an ongoing basis an economic interest of 5% of the notional value of the loans they have granted and subsequently sold on the secondary market.
- To avoid maturity mismatches that may create financial risks, an AIF must adopt a closed-ended structure if the notional value of its originated loans exceeds 60% of its net asset value (NAV).

Further, as noted above, Annex I functions will be expanded to include loan origination. This means that AIFs will be permitted to extend loans anywhere in the EU, including cross-border.

Loan origination: Council and ECON positions

The Council and ECON positions on loan origination diverge from the Commission's proposals in several respects:

- Both the Council and ECON propose carve-outs for shareholder loans, subject to certain conditions.
- In the Council's position, the restriction on lending to a single borrow must apply no later than 24 months from the date the AIF first offers shares for subscription.
- The Council and ECON propose to add to the list of prohibited borrowers delegates of the AIF's depositary, and an entity within the same group as the AIFM, except where that entity is a financial undertaking that exclusively finances borrowers that are not other those to which lending is also prohibited.
- ECON proposes to require retention until maturity, while the Council limits the retention requirement to two years from signing date or maturity, whichever is shorter.
- Both the Council and ECON also add a number of carve-outs to the retention requirement, including in relation to wind downs, sanctions compliance, or to avoid an unintentional breach of the AIF's investment or diversification rules.
- The Council and ECON have proposed to replace the Commission's requirement for an AIF to adopt a closed-ended structure if it originates loans exceeding 60% of its NAV with a more general requirement for the AIF to be closed-ended unless it has a liquidity risk management system which is compatible with its investment strategy and redemption policy. ECON further requires that the liquidity risk management system is "sound" and must be so demonstrated to NCAs, with ESMA to develop regulatory technical standards on the assessment of "sound liquidity management".

The Council and ECON have also introduced new provisions relating to loan origination in their proposals that go beyond the Commission's draft. Both have included a new prohibition on AIFMs from managing AIFs whose investment strategy is to originate loans with the sole purpose of transferring those loans to third parties (i.e., an “originate-to-distribute” investment strategy). The Council's proposal further extends this prohibition to AIFs whose “originate-to-distribute” investment strategy is to gain exposure to loans through a special purpose vehicle which originates a loan for or on behalf of the AIF or AIFM in respect of the AIF.

The Council has also proposed a new limitation on leverage for loan-originating AIFs of 150% of the NAV of the AIF, calculated according to the commitment method.

Finally, both the Council and ECON propose a five-year transition period for AIFMs managing loan originating AIFs before adoption of AIFMD II, and deemed compliance for pre-existing loan originating AIFs that do not raise additional capital (with the Council proposing to allow capital raising to continue until the expiry of the five-year period).

Fund marketing

AIFMD II will amend requirements applying to fund marketing under national private placement regimes (NPPRs), linking EU market access to stronger anti-money laundering and tax compliance. Under current NPPR marketing requirements, the third country where the non-EU AIFM or the non-EU AIF is established must not be listed as a Non-Cooperative Country and Territory by FATF. Under the AIFMD II proposals, this requirement to the FATF list would be removed and replaced by a requirement that the third country must not be identified as a high-risk third country under the Fourth Money Laundering Directive.

Fund marketing: Council and ECON positions

Note that ECON proposes, for closed-ended AIFs only, a two-year grace period from the date of the marketing notification or authorisation where the third country is subsequently added to the list of non-cooperative tax jurisdictions.

Additionally, the third country will need to have signed an agreement with each Member State into which the AIF is to be marketed which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters, including any multilateral tax agreements. The third country also must not be on the EU list of non-cooperative tax jurisdictions. This requirement will be important for fund managers to watch – while the listed jurisdictions do not currently include the third countries most commonly involved in fund management arrangements, it is notable that the Cayman Islands was on the list from February to October 2020.

Despite these proposed changes, non-EU fund managers will be relieved that the AIFMD II proposals do not further harmonise the NPPR framework or enhance the regulatory obligations for marketing under NPPRs, given the significant backlash from the industry to suggestions that more regulatory interventions were needed.

Depositary and custody services

As recommended by ESMA, the European Commission has proposed to amend the regulatory treatment of custodians to bring central securities depositories (CSDs) into the custody chain by providing that CSDs (except issuer CSDs) are subject to custody delegation rules. However, as CSDs are already authorised, depositaries will not need to perform additional due diligence when delegating custody.

Depositaries: Council and ECON positions

The Council and ECON have both preserved the Commission's provisions bringing CSDs into the custody chain. On cross-border access to depositaries, both the Council and ECON propose additional constraints by setting out the criteria to determine under which conditions a market for depositary lacks competitive supply.

The Commission decided not to introduce a depositary passport given the absence of harmonised securities and insolvency laws across EU member states. Instead, proposed amendments will improve access arrangements for depositary services by permitting cross-border access of depositary services where needed until the depositary passport becomes feasible. Recognising that some concentrated markets lack a competitive supply of depositary services, the Commission has proposed that depositaries will no longer need to be established in the same member state as the AIF until the depositary passport is in place (to be considered in a Commission review five years after entry into force). Where a third country depositary is appointed, the same conditions will apply as under the NPPR requirements: the third country will need to have signed an agreement with each Member State into which the AIF is to be marketed (and the home Member State of the AIFM, if different) which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters, including any multilateral tax agreements. The third country also must not be on the EU list of non-cooperative tax jurisdictions.

Reporting and disclosures

AIFMD II will broaden the information to be reported and disclosed by AIFMs. The Commission has proposed to amend Article 24 of the AIFMD to remove limitations on the data that NCAs are able to request from AIFMs on the AIFs they manage.

However, the precise boundaries of the data that NCAs can request remain unclear. ESMA is empowered to develop regulatory technical standards specifying the details to be reported, and must take into account other reporting requirements AIFMs are subject to as well as considerations as to reducing duplication and inconsistencies between the reporting frameworks in the asset management sector and other sectors of the financial industry. Fund managers should keep a watching brief as these requirements begin to take shape.

Reporting: Council and ECON positions

The Council and ECON propose to require detailed reporting about delegation and sub-delegation arrangements, with data items similar to those in the Commission's proposed delegation notifications

ECON also proposes to require the AIFM to report the total amount of leverage of the NAV employed by the AIF.

ESG

While the Commission and Council are silent on environmental, social and governance (ESG) matters, ECON has included provisions relating to sustainability in its position. ECON proposes to require an AIFM applying for authorisation to include information on how it intends to comply with its obligations under the Sustainable Finance Disclosure Regulation (SFDR), including details on the human and technical resources to be used for compliance. ECON also states that AIFMs should ensure that their remuneration policies are consistent with long-term risks, including ESG risks, and sustainability goals, particularly where AIFMs make claims as to the sustainable investment policies of the AIFs that they manage. To that end, ECON suggests that ESMA should update its guidelines on sound remuneration policies under the AIFMD as regards aligning incentives with ESG risks in remuneration policies.

Unresolved matters

ESMA had recommended that the Commission consider further clarifications on the application and scope of the AIFMD and MiFID II rules, in order to reduce legal uncertainty and harmonise divergent Member State views, reflecting, for example, the differing views held by individual Member States on which rules apply where investment management functions for an AIF are performed on a delegated basis. ESMA had also noted that references in Article 6(6) of AIFMD (which requires AIFMs with MiFID top-up permissions to comply with certain obligations under MiFID) had not been updated to refer to MiFID II, meaning that certain new obligations that were introduced or revised in MiFID II do not apply to AIFMs when carrying on MiFID business – including, notably, transaction reporting under Article 26 of the Markets in Financial Instruments Regulation (MiFIR). In response, the Commission has proposed to update Article 6(6) of AIFMD to refer to obligations under the MiFID II framework, proposals which have been preserved in the Council and ECON positions. However, the Commission, the Council and ECON have declined to further clarify the precise application of MiFID II rules, and as a result divergent Member State practices are likely to continue.

Further, despite ESMA's exhortation to the Commission to “seize the opportunity” and address divergent Member State interpretations on the definition of "reverse solicitation", the Commission, the Council and ECON have all declined to address the issue in their proposals. Further clarity for the industry may come when the Commission issues its delayed report on reverse solicitation required by the Regulation and Directive on cross-border distribution of collective investment undertakings.

Expected timing and next steps

Tripartite negotiations on the AIFMD II proposals are underway, with a final agreed version of the text anticipated later in 2023. Once agreed, the amendments will need to be finalised - we anticipate that they may enter into force in late 2023. Member States will then have 24 months to transpose the legislation and new requirements into national legislation, with legislative changes expected to take effect in late 2025.

While the positions taken by the three institutions are not significantly divergent, there areas for the industry to watch in the negotiations, particularly in relation to loan origination and liquidity risk management, where the differing approaches taken will need to converge and there may be scope to influence the outcome of negotiations as the final form of AIFMD II takes shape.

Contact Us

Caitlin McErlane
Partner
caitlin.mcerlane@bakermckenzie.com

Kimberly Everitt
Senior Knowledge Lawyer
kimberly.everitt@bakermckenzie.com