European Commission Review of the AIFMD

November 2021

The European Commission ("**Commission**") is required, under the terms of the AIFMD, to conduct a review of the operation of the directive. Having conducted its evaluation of the AIFMD, the Commission concluded that the AIFMD has 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. On 25 November 2021, the Commission published the Capital Markets Union ("**CMU**") Legislative Package, delivering on several of the key commitments the Commission set out in its 2020 CMU Action Plan and putting forward targeted proposals to take account of new developments in the market since the AIFMD's entry into force and addressing elements of the framework that were not sufficiently addressed at the time of its inception.

The package includes four legislative proposals, including:

- a proposal to amend the Alternative Investment Funds Managers Directive ("**AIFMD**");
- a proposal to amend the European Long-Term Investment Funds ("**ELTIF**") Regulation;
- a proposal to amend the Markets in Financial Instruments Regulation ("**MiFIR**") and for an EU Consolidated Tape; and
- a proposal to create a European Single Access Point ("**ESAP**") for company financial and sustainability-related data.

A letter from the European Securities and Markets Authority ("**ESMA**") published in August 2020 in relation to the Commission's review of the AIFMD had led to concerns that further restrictions on delegation might be introduced, but the targeted approach adopted by the Commission to its review does not introduce such restrictions, although it introduces new notification requirements relating to delegation arrangements. This briefing note outlines the key amendments to the AIFMD proposed by the Commission, which will impact both alternative investment funds ("**AIFs**") and UCITS, as the proposal includes amendments which would harmonise rules between the AIFMD and the UCITS Directive on delegation, liquidity risk management and reporting. The amendments also address the provision of depositary and custody services and loan origination by alternative investment funds.

Delegation

The Commission acknowledges that the delegation regime allows for efficient management of investment portfolios and for sourcing the necessary expertise in a particular geographic market or asset class. However, the Commission observes that differing national supervisory practices in fulfilling the EU requirements for delegation of risk or portfolio management to third parties create inconsistencies that may reduce the overall level of investor protection.

The review concluded that ESMA should be provided with more information on delegation arrangements in the cases where risk or portfolio management is delegated outside the EU and should make use of already available powers such as conducting peer reviews. It is therefore proposed that ESMA should receive notifications of delegation arrangements where more risk or portfolio management is delegated to third country entities than is retained. ESMA is empowered to develop draft regulatory technical standards prescribing the content, forms and procedures for the transmission of delegation notifications. ESMA will be required to present regular reports analysing market practices regarding delegation, compliance with the requirements applicable to delegation, and supervisory convergence in this area to the European Parliament, the Council of the EU and the Commission to "facilitate informed policy decision in this area". This might suggest that restrictions on delegation to third countries may be introduced in the future, depending upon the content of these ESMA reports.

An AIFM or UCITS management company would be required to employ or commit at least two EU residents on a full-time basis to conduct the AIFM's business.

The UCITS framework would be aligned with the AIFMD framework so that a UCITS would be required to justify its entire delegation structure based on objective reasons. The Commission proposes to extend the Level 2 implementing rules under the AIFMD in relation to delegation to UCITS.

Sub-delegation is explicitly banned to non-authorised entities.

Liquidity Risk Management

The Commission's proposal includes measures regarding the availability and use of liquidity management tools ("**LMTs**") during times of market stress. The ability to activate LMTs can protect the value of investors' money, reduce liquidity pressure on the fund and mitigate against broader systemic risk implications in situations of market-wide stress. In addition to being able to suspend redemptions, it is proposed that AIFMs and UCITS management companies would be required to choose at least one other LMT from the relevant annexes (which harmonise the minimum list of LMTs that should be available anywhere in the EU) and to include this in fund rules or instruments of incorporation. AIFMs would be required to notify competent authorities about activating or deactivating an LMT.

Competent authorities would be empowered to require that an AIFM activates or deactivates a relevant LMT.

Loan Origination by AIFs

It is proposed to amend the AIFMD to require that AIFMs of loan-originating AIFs implement effective policies, procedures and processes for the granting of loans. Lending would be restricted to a 20% limit for a single borrower, when this borrower is a financial institution or AIF / UCITS, to reduce the risk to the financial system. An AIF would be prohibited from lending to its AIFM or its staff, its depositary or its delegate. It is proposed that AIFs would be required to retain an economic interest of 5% of the notional value of loans they have granted and sold off, to avoid moral hazard situations where the loans are originated to be immediately sold off on the secondary market. AIFs would be required to adopt a closed-ended structure where they engage in loan origination to a significant extent (60%). Ireland was the first EU member state to introduce a specific regulatory framework for loan originating investment funds and there is some overlap between the general principles proposed by the Commission and the Irish rules, although the Irish framework may need to be amended to align with the final provisions.

Depositary Rules

Central securities depositaries ("**CSDs**") would be brought into the custody chain where they are providing competing custody services, with a view to levelling the playing field among custodians and ensuring that depositaries have access to the information needed to carry out their duties. Depositaries would be relieved from the requirement to perform ex-ante due diligence where the custodian is a CSD because the CSD has been sufficient vetted when seeking to be authorised as a CSD.

The proposal does not include the introduction of a depositary passport. However, member states are to allow depositary services to be procured in other member states until the introduction of a depositary passport.

Depositaries will be required to cooperate with additional national competent authorities ("NCAs") in addition to the home NCA, including the NCA of the AIF that has appointed the depositary and to the NCAs of the AIFM.

Reporting

The Commission has proposed that limitations to data reporting would be removed which could result in full portfolio reporting rather than reporting on "main instruments traded". ESMA is given a mandate to amend the Annex IV reporting template.

Fees and Charges

AIFMs would be required to disclose 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. AIFMs would be required to report on a quarterly basis on all direct and indirect fees and charges that were directly or indirectly charged or allocated to the AIF or to any of its investments.

Next Steps

The publication of the proposal by the Commission is the first step in the legislative process and there is likely to be significant debate between the EU law-making institutions on the proposals over the coming 12 to 18 months, which may lead to changes to the proposed text. Member states will have 24 months after entry into force of the amending directive to transpose the requirements into national law.

The targeted approach of the Commission in its review of the AIFMD is welcome, as it acknowledges the success of the AIFMD framework to date, which has contributed to a decade of growth in the European AIF market and has proven resilient throughout recent market stresses. The European Fund and Asset Management Association ("**EFAMA**") has cautioned against adopting an overly prescriptive approach to the use of LMTs, stating that the application of these tools should be at the manager's discretion and should depend on the individual characteristics of the funds they manage.

EFAMA has also noted that UCITS are already subject to strict product rules and therefore the utility of introducing a reporting regime for UCITS is questionable. The association also warns against the possibility of unintended consequences with regard to the proposed changes to the delegation and outsourcing requirements, noting that the delegation regime is tried and tested and works to the benefit of investors.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.

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