

## ADVISORY | INDUSTRY INFORMATION

# AIFMD II – A closer look

## Introduction

On 10 November 2023, the Council of the EU (the "Council") published the final [compromise text](#) of the political agreement (the "**Agreement**") for a directive<sup>1</sup> amending the Alternative Investment Fund Managers Directive ("AIFMD") and the UCITS Directive with the aim of harmonising rules on delegation, reporting and liquidity management under the AIFMD and the UCITS frameworks. The publication of the Agreement follows on from the provisional agreement reached by the EU's institutions on 19 July 2023 and is a key element of the European Commission's (the "EC") [Capital Markets Union package](#). Walkers have published the following advisories on preliminary work relating to the Agreement:

- [Proposal to amend the AIFMD](#)
- [AIFMD – Room for Improvement](#)

In the Agreement, it is noted that it is necessary to make amendments to the AIFMD to address regulatory gaps and to improve the functioning of AIFMD. In particular, it is noted that there is a need to harmonise rules for alternative investment fund managers ("AIFMs") managing alternative investment funds ("AIFs") which originate loans, to clarify standards applicable to AIFMs that delegate their functions to third parties, to ensure equal treatment of custodians, to improve cross-border access to depositary services, to optimise supervisory data collection and to facilitate the use of liquidity management tools. While the Agreement also sets out a number of mirroring changes to the UCITS Directive what follows is a brief overview of some of the key proposed amendments to AIFMD described in the Agreement. This advisory also details next steps and the key milestones in the proposed implementation of the measures contained in the Agreement.

The provisions discussed in this note generally apply in respect of EU full-scope AIFMs. Provisions in the Agreement regarding Article 23 pre-contractual disclosures to investors and Annex IV transparency reporting will also be relevant for non-EU AIFMs marketing AIFs under national private placement regimes.

<sup>1</sup> Proposal for a Directive of the European Parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds (2021/0376 (COD)).

## 1. Loan Origination

A harmonised framework for loan originating funds is introduced in the Agreement in order to improve risk management across the financial market and increase transparency for investors. The loan origination provisions included in the Agreement apply in respect of all AIFs which engage in "loan origination" or "originating a loan" however certain of the loan origination provisions only apply in respect of AIFs which engage significantly in loan origination (falling within the definition of a 'loan-originating AIF' as specified below). There are certain exemptions from specific aspects of the loan origination regime in the Agreement in respect of shareholder loans. It is noted in the recitals to the Agreement that for overriding reasons of public interest, member states should also be able to prohibit loan origination by AIFs to consumers in their territory.

"Originating a loan" involves

- the granting of a loan directly by an AIF (as the original lender); or
- indirectly through a third party or special purpose vehicle ("SPV"), which originates a loan for or on behalf of the AIF, or for or on behalf of AIFM in respect of the AIF, where the AIFM or AIF is involved in structuring the loan, or defining or pre-agreeing its characteristics, prior to gaining exposure to the loan.

A "loan-originating AIF" is defined in the Agreement as an AIF

- whose investment strategy is mainly to originate loans; or
- where the notional value of the AIF's loans represents at least 50% of its net asset value.

The Agreement establishes rules in relation to the maintenance of specific policies and procedures in relation to loan origination activities. AIFs that engage in loan origination are required to have effective policies, procedures and processes for the granting of loans, assessing credit risk and administering and monitoring the credit portfolio, including when AIFs gain exposure to loans through third parties. Such policies should be reviewed periodically.

The Agreement also sets out prohibitions on lending to certain types of borrowers, including the AIFM, the AIF's depository and their delegates. AIFs which originate loans are prohibited from lending more than 20% of its capital to a single borrower which is a financial undertaking or a fund.

The Agreement also contains a risk retention requirement whereby AIFs which originate loans must retain an interest of 5% of the notional value of any loan it originates which is sold on the secondary market for the following period (subject to limited exceptions):

- i. until maturity or those loans whose maturity is up to eight years, or for loans granted to consumers regardless of their maturity; and
- ii. for a period of at least eight years for other loans.

Loan-originating AIFs are required to comply with the leverage limits set out in the Agreement. An AIFM is required to ensure that the leverage of a loan-originating AIF it manages represents no more than:

- i. 175 %, where that AIF is open-ended;
- ii. 300 %, where that AIF is closed-ended, (in each case expressed as the ratio between the exposure of that AIF, calculated according to the commitment method and its net asset value).

It is noted in the recitals to the Agreement that the leverage limitations should not prevent the relevant national competent authority ("NCA") from imposing stricter leverage limits where it is deemed necessary to ensure the stability and integrity of the financial system.

Loan-originating AIFs are also required to be closed-ended, however a loan origination AIF may be open-ended provided that the AIFM is able to demonstrate to its NCA that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. In order to ensure consistent criteria for the determination by NCAs of whether a loan origination fund can maintain an open-ended structure, ESMA will develop draft regulatory technical standards to establish those criteria.

The Agreement contains certain grandfathering provisions in respect of the AIFs which engage in loan origination that have been constituted before the date of entry into force of the amending directive adopting the Agreement (the "Effective Date") giving them five years to comply with certain aspects of the Agreement. It is important to note that the five year period runs from the date the amending directive is adopted not from when the national regulations implementing the Agreement become effective. Where such AIFs do not comply with the leverage or diversification limits set out in the Agreement as of the Effective Date, they are not permitted to increase the value of the loans to a single borrower or the amount of leverage incurred. AIFMs managing AIFs that originate loans that have been constituted before the Effective Date that do not raise additional capital after the Effective Date are deemed to comply with a number of the provisions. There is also an exemption in respect of the application of certain of the requirements for loans which have been originated prior to the Effective Date.

From an Irish perspective, the Central Bank of Ireland ("Central Bank") already has a loan-originating AIF (L-QAIF) regime which broadly aligns with the requirements in the Agreement. It is noted that in a [recent speech](#) to industry at the Irish Funds Annual UK Symposium Derville Rowland, Deputy Governor of the Central Bank confirmed that the changes agreed as part of the AIFMD II review are appropriately targeted and the harmonisation of the rules for funds which undertake lending activity is seen as a positive development. In due course, the Central Bank will move to bring the provisions of the domestic loan origination framework into alignment with that of AIFMD II.

## 2. Liquidity Risk Management

Against the background of increasing global focus on liquidity risk and its management in open-ended funds, the Agreement aims to harmonise liquidity management tool ("LMT") rules in member states. The Agreement introduces a new Annex whereby AIFMs of open-ended AIFs will be required to choose at least two LMTs and include these in the AIF's constitutional documents for possible use in the interest of the AIF's investors. AIFMs of money market funds are only required to select one LMT in respect of the relevant money market fund. An AIFM is required to communicate to its home state NCA the selection it has made and its policies and procedures for the activation and deactivation of LMTs and the NCA is required to notify other host NCAs and ESMA and, if there are potential risks to the stability and integrity of the financial system, the European Systemic Risk Board. NCAs have the power, in exceptional circumstances (and after consultation with the AIFM) to require AIFMs to suspend, or cease the suspension of, redemptions and subscriptions. The Agreement provides that an AIFM may only suspend the redemption of AIF units or shares or activate side pockets in exceptional cases where circumstances so require and where justified having regard to the interests of the AIF's investors. The use of redemption in kind as an LMT may only be activated to meet redemptions requested by professional investors. ESMA is required to develop certain guidelines, including on the selection and calibration of LMTs which allow adequate time for adaptation before they apply, in particular for existing AIFs.

## 3. Delegation

The Agreement also contain amendments in respect of delegation by an AIFM. In its application for authorisation, and on an ongoing basis as part of reporting to NCAs, an AIFM will be required to include information in respect of arrangements made for the delegation and sub-delegation to third parties including, for example, name, jurisdiction of establishment and supervisory authority of the delegate and detailed descriptions of the delegated functions and how the delegation will be monitored by the AIFM. By five years after the Effective Date, ESMA is required to provide the EU institutions with a report analysing market practices regarding delegation in compliance with the Agreement, which will lead to delegation practices remaining under scrutiny in the future.

## 4. AIFM Substance Requirements

The Agreement requires AIFMs to provide, as part of the NCA authorisation process, detailed information on the human and technical resources that will be utilised in connection with the applicant AIFM's business activities. The Agreement requires that at least two natural persons, domiciled in the EU, are employed by the AIFM or are executive members of the AIFM on a full time basis in order to conduct the business of the AIFM. The Agreement notes that regardless of this statutory minimum, more resources may be required depending on the size and complexity of the AIF. In the recitals to the Agreement, it is noted that it is appropriate to encourage AIFMs managing AIFs marketed to retail investors to appoint at least one independent or non-executive director. From an Irish perspective these rules are consistent with the Central Bank of Ireland's existing approach to minimum substance requirements for AIFMs.

## 5. Depositaries

NCAs are permitted to allow depositaries established in an EU member state other than that of the AIF to be appointed as a depositary to the AIF provided that certain conditions are met including that the NCA has received a request from the AIFM in relation to such appointment which demonstrates:

- the lack of relevant depositary services in the home member state; and
- the aggregate amount in the national depositary market of the home member state of the AIF assets safekept on behalf of EU AIF and managed by an EU AIFM does not exceed EUR 50 billion.

Even if the conditions are met, NCAs are only permitted to allow the appointment of a depositary in another member state after a case by case assessment and must notify ESMA if they permit such appointment to be made.

## 6. Ancillary Activities

The list of non-core services which can be carried out by AIFMs has been expanded to include administration of benchmarks and credit servicing. Article 6(5)(b) of AIFMD has been deleted whereby the portfolio management 'top up' permission is no longer a pre-requisite in order to be authorised for other non-core services.

Originating loans on behalf of an AIF and servicing securitisation SPVs are also included as permitted ancillary activities for authorised AIFMs which may be carried out in the course of the collective management of an AIF. This would allow for loan origination activities to be carried on in other member states on a cross-border basis.

## 7. Managing AIFs at the Initiative of a Third Party

Interestingly, the Agreement contains a new requirement which will be relevant for third party AIFMs. The Agreement requires AIFMs which manage or intend to manage an AIF at the initiative of a third party (including AIFs using the name of the third party initiator or appointing the third-party initiator as a delegate) to submit to its NCA, taking account of conflicts of interest, detailed explanations and evidence of its compliance with Article 14(1) and 14(2) of AIFMD 'Conflicts of Interest'.

In particular, the AIFM is required to specify what reasonable steps it has taken to prevent conflicts of interest arising from the relationship or, where they cannot be prevented, how it identifies, manages and monitors and where applicable, discloses those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors. There is no further detail on how this information should be provided by AIFMs to NCAs.

## 8. Costs

For the purposes of assessing compliance with the requirement on member states to ensure at that all times AIFMs treat all investors fairly, ESMA is required under the Agreement to submit a report to the European Parliament, the Council and the EC within 18 months from the Effective Date assessing the costs charged by AIFMs to the investors of AIFs that they manage and explaining the reasons for the level of those costs and for the differences between them. For the purposes of preparing that report, the NCAs are required to provide ESMA with data on costs, including all fees, charges and expenses which are directly or indirectly allocated to the AIF. The Agreement notes that the NCAs have the power to require AIFMs to provide information as set out in Article 46(2) of the AIFMD. The Agreement also contains updates to Article 23 of the AIFMD in relation to disclosure of fees, charges and expenses including that the AIFM disclose on an annual basis to investors all fees, charges and expenses that were directly or indirectly borne by investors. For further information on recent EC proposals on costs and charges read our recent advisory on the [Adoption of the European Commission's retail investment strategy](#).

## Next steps

The European Parliament is set to consider the final text of AIFMD II during its plenary session to be held on 5 February 2024. In the meantime there will be a further drafting review of the Agreement before the measures set out in the Agreement are adopted and published in the Official Journal of the European Union (the "Journal") which can be expected by the end of Q1 2024. Member states will need to transpose these measures into local legislation within 24 months of the publication of these measures in the Journal, apart from measures implementing reporting requirements which have 12 further months to take effect and subject to the grandfathering period for certain of the loan origination provisions. ESMA and the EC will also work to develop various Level 2 delegated acts. Accordingly, it is estimated that the majority of the provisions in the Agreement will be implemented across the EU by the first half of 2026.

## Further information

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