

WHAT YOU NEED TO KNOW ABOUT THE AMENDMENTS TO THE AIFM AND UCITS DIRECTIVES MADE IN THE AIFMD II



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Building upon the success and lessons learned from the Alternative Investment Fund Managers Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 (“AIFMD”) and from the Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on undertakings for collective investments in transferable securities (“UCITS Directive”), the European Commission published a legislative proposal on 25 November 2021 amending the AIFMD and the UCITS Directive to strengthen investor protection, enhance market transparency and streamline regulatory processes in the ever-evolving world of alternative investments. The interinstitutional negotiations between the European legislators led to a compromise text “Confirmation of the final compromise text with a view to agreement” on 6 November 2023 (the “Compromise text”) which included several amendments to the initial draft and was adopted today (the 7th February 2024) by the European Parliament (referred hereinafter to as the “AIFMD II”). For the final adoption of the AIFMD II, the European Council still needs to accept the text.

In this article, we will explore the key changes and implications of the AIFMD II and its impact on fund managers, investors, and the financial industry as a whole.

1. INTRODUCTION

The AIFMD II introduces several amendments which mainly relate to:

- Substance in terms of technical and human resources requirements.
- Clarification of rules applicable to AIFMs that delegate their functions to third parties.
- Facilitation of the use of liquidity management tools (“**LMTs**”) across the Union.
- Inclusion of central securities depositories (“**CSDs**”) into the custody chain.
- Optimization of supervisory data collection.
- Harmonization of rules for AIFMs managing loan-originating alternative investment funds (“**AIFs**”).
- Improving the cross-border access to depositary services.
- Extension of permitted activities (ancillary services) as well as persons who may benefit from the AIFM services.
- Integration of ESG parameters.
- Additional transparency requirements for AIFMs.
- Clarifications in respect to AML and tax conditions for third country entities wishing to access internal market.

The AIFMD II provides some amendments to the UCITS Directive for harmonization purposes with the AIFMD, where there was no reason to maintain any regulatory differences.

Although the EU Member States will have 24 months after the entry into force of the AIFMD II to implement it into their national laws, it is however important for the market participants to assess in advance the changes which may impact their business to prepare for the adaptations or consider new business opportunities offered to them.

2. WHAT ARE THE CHANGES?

2.1. SUBSTANCE REQUIREMENTS

The additions made in AIFMD II to the AIFMD and the UCITS Directive aim at clarifying that when applying for authorization, fund managers will have to demonstrate the appropriate technical and human resources envisaged to carry out their functions, and where applicable, to supervise their delegates. This will have to be described in detail at the time of application for authorization. In terms of human resources, the AIFMD II states that at least two natural persons will have to either be employed or be appointed as executive members or members of the governing body of the AIFM and the UCITS management company (“**UCITS ManCo**”). It is further stated that these two natural persons will need to work on a full-time basis and be domiciled (i.e. have their habitual residence) in the European Union. Depending on the size and the complexity of the AIF, these minimum requirements may not be sufficient, and more resources may be necessary.

The AIFMD II also encourages the fund managers to appoint at least one independent or non-executive director who shall be independent in character and in judgement and has sufficient expertise and experience to assess if the funds are managed in the interest of their investors.

2.2. DELEGATION REGIME

AIFM / UCITS ManCos often delegate their services to third parties to increase efficiency and have access to external expertise. From an operational perspective, technical and human resources are however still required for the AIFM / UCITS ManCos to supervise and control the delegated functions, incurring a substantial amount of fees and in some cases, an increase of risks.

To allow the authorities to obtain sufficient and reliable information on delegation activities, additional measures have been deemed necessary in terms of delegation reporting. AIFM and UCITS ManCos should regularly provide national competent authorities (“**NCAs**”) with information on delegation arrangements, which involve the delegation of collective or discretionary portfolio management or risk management functions. The AIFMD II contains a list of minimum information that needs to be transmitted to NCAs.

The AIFMD II seeks to align the UCITS Directive with the AIFMD, as the rules on delegation were not as much detailed for UCITS as they were for AIFMs¹. UCITS management companies would be required to justify the delegation of their functions based on objective reasons. The Commission shall also specify the conditions for delegation by a UCITS ManCo to a third party and in which case it can be considered as a letter-box entity.

Furthermore, the AIFMD II clarifies that the delegation rules will apply to all the functions listed in Annex I of the AIFMD and Annex II of the UCITS Directive as well as to the ancillary services.

The AIFMD II has also specified the treatment of distribution arrangements. Unlike distributors acting on behalf of the AIFM/UCITS ManCos based on arrangements, distribution arrangements whereby a distributor acts on its own behalf when it markets the AIF under Directive 2014/65/EU² or Directive 2016/97/E³ should not be considered as a delegate of the AIFM/UCITS ManCo, notwithstanding any distribution agreement between the AIFM/UCITS ManCo and the distributor. In such a case the provisions of the AIFMD/UCITS Directive on delegation should not apply.

ESMA shall provide the European Parliament, the Council and the European Commission with a report analyzing the different market practices, among which also on delegation, 60 months after the entry into force of the AIFMD II.

2.3. LIQUIDITY RISK MANAGEMENT AND LIQUIDITY MANAGEMENT TOOLS (LMTS)

LMTs allow managers of open-ended funds to address redemptions made under stressed market conditions and safeguard their investors' interests. There was a real need for harmonising LMTs across the European Union, as they were, until the AIFMD II, mostly based on guidelines and recommendations from the different European authorities⁴. The LMTs in the AIFMD II stem from the recommendations made by the European Systemic Risk Board (ESRB) on "*liquidity and leverage risks in investment funds*" issued on 7 December 2017.

As mentioned above, fund managers of open-ended funds have always had the possibility to suspend the redemptions or repurchase of shares in exceptional circumstances, whenever detailed in the fund documentation. However, the AIFMD II introduced the requirement for fund managers to choose in addition at least two LMTs (and one LMT for managers of money market funds) from points 2) to 7) of

¹ Cf. Article 82 of the Commission Delegated regulation 231/2013 which contains conditions under which an AIFM should no longer be considered to be managing an AIF and considered as a letter-box entity.² Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

² Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

³ Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast).

⁴ In Luxembourg the Circular CSSF 19/733 IOSCO recommendations - Liquidity risk management for open-ended undertakings for collective investment implemented the IOSCO recommendations of February 2018, but this was not the case of all members of the EU.

the Annex V to the AIFMD and Annex IIA of the UCITS Directive, which contains the minimum list that should be available in the Union, and includes:

1. suspension of redemptions and subscriptions,
2. redemption gate,
3. extension of notice periods,
4. redemption fee,
5. swing pricing,
6. dual pricing,
7. anti-dilution levy,
8. redemption in kind; and
9. side pockets.

Most of these tools were already available and used in Luxembourg, but this was not the case in all EU Member States.

In addition to the two LMTs from points 2) to 7), AIFMs of open-ended AIFs would always have the possibility to temporarily suspend redemptions and subscriptions or activate side pockets in exceptional circumstances only and when duly justified, in the interests of the AIF's investors.

Any activation or deactivation of a LMT by a fund manager must be notified to the competent authority. The home competent authorities of the relevant fund manager will then in turn notify, without delay, the competent authorities of a host Member State of the fund manager, the ESMA and, in case of potential risks to the stability and integrity of the financial system, the ESRB of any such notification received. ESMA will have the possibility to share the information received with the competent authorities. Characteristics of LMTs will be described in regulatory technical standards ("RTS"). ESMA shall also develop guidelines on the selection and calibration of LMTs by AIFMs within 12 months from the entry into force of the AIFMD II.

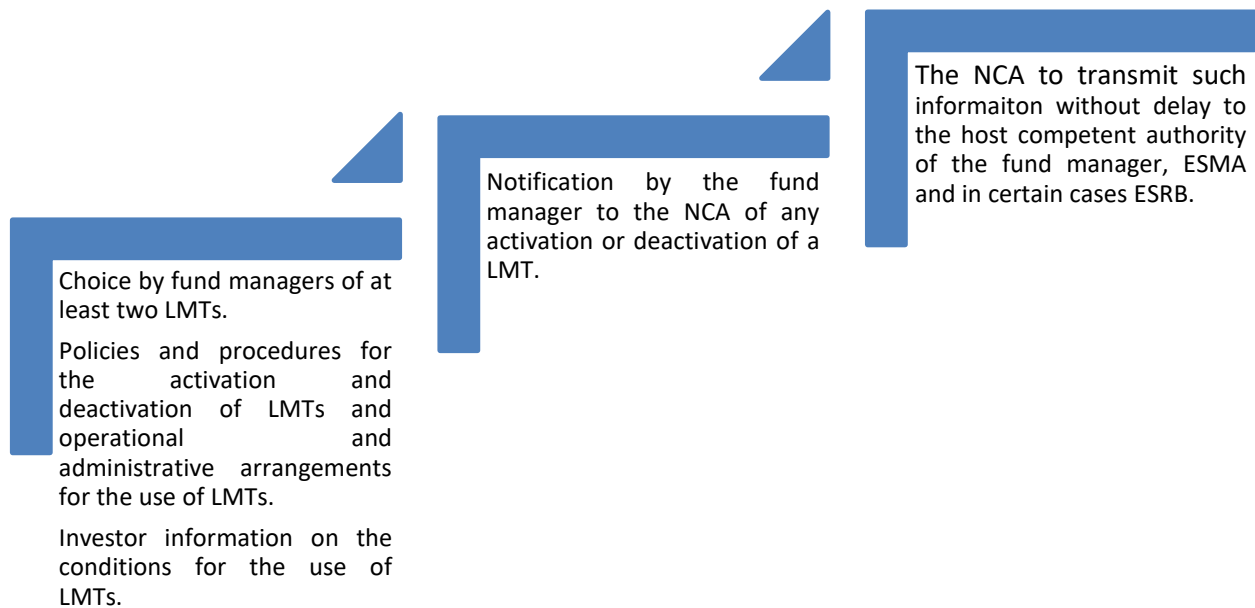
The AIFMD II has specified that the use of redemptions in kind is not suitable to retail investors and should only be offered to professional investors. By offering redemption in kind, equal treatment between redeeming investors and other unitholders or shareholders should be ensured.

After the selection of the LMTs, the AIFM and UCITS ManCo shall implement detailed policies and procedures for the activation and deactivation of any selected LMT and the operational and administrative arrangements for the use of such tools.

Investors should be informed of the conditions for the use of LMTs to be able to make better decisions in line with their risk appetite and liquidity needs. Usually, such information is inserted in the fund's prospectus.

Characteristics of LMTs will be specified in RTS. In addition, ESMA should prepare guidelines on the selection and calibration of LMTs by AIFMs/UCITS ManCos, which shall recognize that the primary responsibility for liquidity risk management remains with the AIFM/UCITS ManCo.

Notification process in relation to the use of LMTs



2.4. INCLUSION OF CSDS INTO CUSTODY CHAIN

Entrusting the provision of custody services to an operator of securities settlement system (CSD) was not considered as delegation of custody functions under the AIFMD and UCITS Directive⁵. However, it has been noted that the exclusion of CSDs from the custody chain prevented a stable flow of information on portfolio movements between the custodian of AIFs/UCITS assets and the depositary hindering depositaries from fulfilling their oversight duties effectively.

With the AIFMD II, CSDs have hence been included in the custody chain whenever they provide custody services. A CSDs definition has now been added to the AIFMD and UCITS Directive by reference to Regulation (EU) 909/2014⁶. The depositaries have however been discharged from an *ex-ante* due diligence requirement on CSDs acting as custodians as CSDs are already subject to regulation and supervision.

⁵ Recital (41) of the AIFMD, Article 21(11) AIFMD; Article 22a)4) of UCITS Directive.

⁶ Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.

2.5. DATA REPORTING

The AIFMD II intends to improve the data collection and remove inefficient reporting duplications. The European supervisory authorities (ESAs) and the European Central Bank (ECB), with the support of competent authorities where necessary, will assess the data needs of different supervisory authorities in view of an efficient change of the supervisory reporting template for AIFMs.

ESMA will provide draft RTS together with implementing technical standards (ITS) to standardize the supervisory reporting process by AIFMs/UCITS.

To reduce duplicative reporting, data reported by the AIFMs/UCITS to their NCAs may be available to other relevant competent authorities, ESMA, the other ESAs and the ESRB when necessary to carry out their duties, and to ESCB for statistical purposes.

The AIFMD II also provides for information exchange between the competent authorities and tax authorities.

Supervisory cooperation: the host Member State competent authority may request the home Member State's competent authority to take supervisory action against an AIFM or UCITS. The request shall specify the reasons for its request.

Case presentation: ESMA may request a competent authority to present a case before its standing committee, which may have cross-border implications or an impact on financial stability or investor protection, this will create a better understanding of the issue for other competent authorities and avoid similar instances in the future.

2.6. LOAN ORIGINATION

In some Member States, AIFs were not allowed to originate loans, or this right was reserved to locally established funds. ESMA has expressed its opinion back in 2016⁷ that a framework for loan origination AIFs and their managers was necessary to “mitigate risks arising from liquidity and maturity transformation, as well as risks related to imprudent lending” to avoid systemic risk due to credit provided by such entities and divergences across the EU.

With the AIFMD II, Annex I of the AIFMD has been amended to recognize the right of the AIFMs to originate loans on behalf of the AIFs. AIFs may thus extend loans anywhere in the European Union. This harmonization will hopefully create business opportunities beyond the borders of the home Member State and allow small and medium enterprises to get alternative sources of finances, who are

⁷ Key principle for a European framework on loan origination funds dated 11 April 2016

more prone to being unable to secure credit loans from banks. It should be noted that according to the AIFMD II, Member States will have the possibility to provide for more restrictive rules in the national product framework applicable to certain category of AIFs.

Indirect loan origination: To avoid circumvention of the AIFMD, granting of loans indirectly (through a third party or a special purpose vehicle) would be considered as loan originating activity and would fall under the scope of the AIFMD.

Loan origination to consumers: granting loans to consumers is subject to specific legal frameworks providing for basic protection of borrowers in the European Union. Member States will have the option to prohibit loan origination by AIFs to consumers in their jurisdiction.

Risk management requirements: AIFMs managing AIFs that engage in loan origination (regardless if these AIFs meet the definition of loan-originating AIFs) will have to implement effective policies, procedures, and processes for this activity as well as for the assessment of credit risk, administering and monitoring of the credit portfolios where AIFs under their management engage in loan origination and /or gain exposure to loans through third parties. Such policies, procedures and processes should be proportionate to the extent of loan origination and be reviewed periodically, at least once a year.

Risk diversification requirement: AIFMs managing loan-originating AIFs, where a borrower is a financial institution, are required to diversify their risks: the new Article 15 § 4a) provides that an AIFM shall ensure that the notional value of the loans originated to any single borrower by the AIF it manages does not exceed in aggregate 20% of the AIFs capital where the borrower is a financial undertaking within the meaning of Article 13(25) of Directive 2009/138/EC⁸, an AIF or a UCITS. These limits are without prejudice to restrictions provided under the ELTIF, EUVECA and EUSEF regulations.

Conflicts of interest: To avoid any conflict of interests, no lending by an AIF will be permitted to its AIFM or its staff, its depositary or its delegates, delegates of the AIFM and their staff, nor to entities within the same group as the AIFM, except certain financial undertakings.

Risk retention requirements: To avoid loan origination with the sole purpose of selling them (“originate-to-distribute strategy” which shall be prohibited), AIFs will be required to retain an economic interest of 5% of the notional value of the loans they have granted and sold off. The sole purpose of granting loans should be for the investment of the capital raised by the AIF in accordance with its investment strategy and regulatory constraints.

Derogations to the risk retention requirements would however be allowed in the best interest of the AIF’s investors, e.g. if the retention part of the loan is incompatible with the AIF’s investment strategy,

⁸ Article 13(25) provides the definition of a ‘financial undertaking’ which means any of the following entities:

- (a) a credit institution, a financial institution or an ancillary banking services undertaking within the meaning of Article 4(1), (5) and (21) of Directive 2006/48/EC respectively;
- (b) an insurance undertaking, or a reinsurance undertaking or an insurance holding company within the meaning of Article 212(1)(f);
- (c) an investment firm or a financial institution within the meaning of Article 4(1)(1) of Directive 2004/39/EC; or
- (d) a mixed financial holding company within the meaning of Article 2(15) of Directive 2002/87/EC.

regulatory requirements, including product requirements imposed on AIFs and AIFMs such as exceeding investment or diversification limits. Derogations should be justified to the NCAs upon request.

Leverage limits: Liquidity mismatches may arise in the case of long term, illiquid loans held by AIF in open-ended structures, with redemption possibilities. To avoid such risks, AIFs will have to adopt a closed-ended structure whenever they engage in loan origination.

It would however be possible for such funds to operate as open-ended funds under certain conditions (it is demonstrated to the NCAs of the AIFM that the AIFs liquidity management system is compatible with its investment strategy and redemption policy). The criteria for cases where open-ended structures may be used will be determined in RTS. The leverage limit shall vary depending on the open-ended (175%) or closed-ended nature (300%) of the AIF. The limits provided by the AIFMD II are, however, the minimum requirements and may be superseded by stricter leverage limits imposed by the Member States.

It is reminded that that the specific product rules applicable to ELTIF, EUVECA and EUSEF should prevail over the general rules of the AIFMD. The AIFMD II has introduced transitional rules for certain requirements relating to loan origination for the exiting AIFs, with the possibility to opt into the new rules. The new rules relating to loan origination/loan originating AIFs shall apply with respect to loans originated after the entry into force of the AIFMD II, except for the leverage and the investment limits and the obligation for loan-originating AIFs to operate as closed-ended.

2.7. CROSS BORDER DEPOSITARY SERVICES

While there were discussions regarding the granting of a European passport to depositaries, it was however put aside for the profit of a more limited cross-border service provision by depositaries. This possibility will be limited to small markets, with few service providers. To create competition between the service providers and avoid high costs charged to AIFs, the AIFMs or AIFs will be allowed to use depositary services located in other Member States with the prior approval of the competent authorities of the AIF. Even when all conditions provided in the AIFMD II are fulfilled, no automatic right will be created for such appointment but the decision will be taken by the competent authorities on a case-by-case basis, considering the lack of the depositary services in the home member state in light of the investment strategy pursued.

The depositary is an important contact for the supervisory authorities. The authorization to provide cross-border services by the depositaries would also imply strengthened supervision as in addition to their competent authorities, the depositaries will also have to cooperate with those of the relevant AIF and its AIFM, if those competent authorities are located in another Member State than the depositary.

2.8. EXTENSION OF THE LIST OF ANCILLARY SERVICES

Up until now, according to Article 6 (4) of the AIFMD, by derogation to activities permitted in the Annex I of the AIFMD, Member States had the possibility to authorize an external AIFM to provide certain additional services, such as (i) management of portfolios of investments, including those owned by pension funds and institutions for occupational retirement in accordance with mandates given by investors on a discretionary, client-by-client basis; (ii) non-core services including an investment advice, safe-keeping and administration in relation to shares or units of collective investment undertakings and reception and transmission of orders in relation to financial instruments. The AIFMD II has added to such list the tasks carried out by an administrator of benchmarks in accordance with Regulation (EU) 2016/1011⁹ and credit servicing governed by Directive (EU) 2021/2167¹⁰. When undertaking the tasks of administrator of benchmarks or by providing credit servicing services, AIFMs shall be subject to the above-mentioned acts. It should also be noted that AIFMs providing ancillary services involving financial instruments are subject to the MIFID rules, laid down in Directive 2014/65/EU¹¹. With respect to other assets which are not financial instruments, AIFMs should comply with the AIFMD.

A new point 4 will also be inserted in Annex I to legitimate the provision of services by AIFMs to securitization special purpose entities.

2.9. PROVISION OF AIFM SERVICES TO THIRD PARTIES

The AIFMD II granted the possibility for AIFMs and UCITS ManCos to provide their services, i.e services that they already provide in relation to funds under their management (e.g. corporate services: human resources, IT services for portfolio and risk management), to third parties. This is conditioned by an appropriate management of conflicts of interests that may be created by such activity.

In addition, when an AIFM / UCITS ManCo manages a fund at the initiative of a third party, including when the fund is using the name of the third-party initiator or appointing the third-party initiator as a delegate, the AIFM/UCITS ManCo shall submit detailed explanations and evidence of its compliance with the requirements on conflicts of interests to the NCA and explain what reasonable steps it has

⁹ Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.

¹⁰ Directive (EU) 2021/2167 of the European Parliament and of the Council of 24 November 2021 on credit servicers and credit purchasers and amending Directives 2008/48/EC and 2014/17/EU.

¹¹Footnote 2.

taken to prevent conflicts of interests arising from the relationship or, when they cannot be prevented, how it identifies, manages and monitors and, where applicable, discloses those conflicts of interests in order to prevent them from adversely affecting the interests of the AIF/UCITS and their investors.

2.10. INTEGRATION OF ESG PARAMETERS

The Compromise text included new provisions to push fund managers towards the promotion of sustainable growth. AIFMs and UCITS ManCos should demonstrate that they continuously comply with their obligations under the SFDR Regulation¹². Therefore, AIFMs and UCITS ManCos should integrate environmental, social and governance parameters into the governance and risk management rules relating to their investment decisions and risk assessment. It is reminded that the investment decisions and risk assessment shall be made in the best interest of the investors of the AIFs and UCITS. ESMA has been charged to update the existing guidelines on sound remuneration policies to align incentives with ESG risks in remuneration policies.

2.11. ADDITIONAL TRANSPARENCY REQUIREMENTS UNDER ARTICLE 23 OF THE AIFMD

With the aim of conferring more transparency, the AIFMD II has amended Article 23 of the AIFMD by adding disclosures requirements for AIFMs, namely:

- Conditions for using LMTs and the existing redemption arrangements with investors,
- Fees, charges, and expenses that will be borne by the AIFM in connection with the operation of the AIF and be directly or indirectly allocated to the AIF,
- Report to investors the portfolio composition of originated loans,
- On an annual basis, report on all fees, charges and expenses that were directly or indirectly borne by the investors,
- On an annual basis, any parent company, subsidiary or special purpose entity used in relation to the AIF's investments by or on behalf of the AIFM.

Provisions have also been added to ensure uniform use of the name of the AIF. The name is disclosed to investors in pre-contractual documentation and constitutes essential information for the investors. Such information shall be accurate, fair, clear, and not misleading. ESMA shall specify in guidelines circumstances where the name of the AIF or UCITS could be unfair, unclear, or misleading. Sectorial legislation on these aspects should however prevail.

The AIFMD II has specified that Member States should require fund managers to act honestly and fairly as regards the fees and costs charged to investors. Fund managers would be required to establish a

¹² Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

sound pricing process including the requirement to compensate the investors in case of charging undue costs. Although compensation was already an existing market practice, these new provisions aim to create harmonized rules at the EU level. ESMA has been charged to prepare a report assessing the level, reasons for and differences in the costs charged. A common understanding of the notion of undue costs should also be developed by ESMA.

2.12. ADDITIONAL CLARIFICATIONS WITH RESPECT TO AML AND TAX CONDITIONS FOR THIRD COUNTRY ENTITIES WISHING TO ACCESS INTERNAL MARKET

Additional provisions were included to condition access to the internal market to entities from third – countries (non-EU AIFs, non-EU AIFMs and depositaries established in a third country). Such entities must be located in countries which are not identified as a high-risk country according to the latest European laws against money laundering and that are not deemed non-cooperative jurisdictions in tax matters. A grace period of two years has been foreseen when a country is added to one of those lists. The requirement shall also ensure appropriate and effective exchange of information in tax matters in line with international standards (cf. Article 26 of the OECD Model Tax Convention on Income and on Capital).

2.13. CONFIDENTIALITY REQUIREMENTS LOOSENED

With entry into force of the AIFMD II, market data disclosure by ESMA will be possible in an aggregate or summary form, therefore relaxing the confidentiality standard.

We hope that the above Article was useful for your understanding of the main forthcoming changes in the AIFMD world. Should you have any questions, please do not hesitate to contact our investment funds' team by email at welcome@brouxelrabia.lu.