Proposed amendments to the AIFMD and the UCITS Directive. International Bulletin, March 2022.

On 25 November 2021, the European Commission (EC) published its proposal for a Directive amending Directive 2011/61/EU on alternative investment fund managers (the AIFMD) and Directive 2009/65/EC on undertakings for collective investment in transferable securities (the UCITS Directive). The EC reviewed the application of the AIFMD, as established therein, concluding that its objectives have been largely attained. However, to take account of new market developments, it considered it necessary to review certain issues. For this reason, it proposes harmonising the rules relating to the loan-origination by AIFs, clarifying the standards applicable to AIFMs delegation arrangements, ensuring equal treatment of custodians, improving cross-border access to depositary services, optimising supervisory reporting and harmonising and facilitating the use of liquidity management tools. In addition, it also proposes amending a number of these aspects in the UCITS Directive (delegation, custody, supervisory reporting and liquidity management).

Although the proposal especially highlights these amendments, some changes are also introduced in the AIFM regime as regards requirements for information to investors and for AIFMs and AIFs from third countries wishing to access the European Union (EU) market. The activities permitted for AIFMs are also expanded and supervisory cooperation is strengthened in the context of cross-border activity in both Directives.

Sixty months after the entry into force of the amendments to the AIFMD, the EC will assess the impact on financial stability of the availability and activation of liquidity management tools; the effectiveness of authorisation and delegation requirements in avoiding letter-box entities; the adequacy of the regime for loan origination; and the advisability of introducing a passport for depositaries.

The EC proposal is open for comments until 24 March 2022. Subsequently, the legislative procedures of the co-legislators will continue with a view to the approval and publication of the final text in the Official Journal of the EU. Member States will have a period of 24 months from the entry into force of the amended Directives in which to transpose it into their national legislation.

Proposed amendments affecting only the AIFMD

Permitted Activities for AIFMs

Included as legitimate activities are loan origination and servicing of securitisation special purpose entities, while ancillary services will include activities permitted in other Union regulations such as benchmark administration and credit servicing.

Loan origination

The requirements set out in the AIFMD are not specific enough to capture the particularities of AIFs' loan origination activity. The fragmentation of the national frameworks that regulate the activity makes it difficult to identify and react to the possible effects of these activities and the creation of an efficient internal market that would offer more financing opportunities for SMEs. The proposal establishes a framework with the following requirements:

AIFMs managing AIFs that engage in lending activities must implement effective policies, procedures and processes for the granting of loans, assessing credit risk and administering and monitoring their credit portfolios. These should be reviewed at least annually. Also, to reduce the risk of the financial sector, a loan originated for any single borrower may not exceed 20% of AIF's capital where the borrower is a financial institution or a collective investment scheme. To avoid conflicts of interest, the AIF is prohibited from lending to its AIFM, its staff, its depositary or its delegate. To prevent poor quality loans from being created and immediately sold on the

secondary market, it is proposed that AIFs be required to retain 5% of the notional value of the loans that they originate and sell. To avoid maturity mismatches that could create financial risks, it is proposed that AIFs be required to be closed-ended if the notional value of its originated loans exceeds 60% of its net asset value. The inclusion of loan origination as a legitimate activity of AIFMs allows AIFs to grant loans on a cross-border basis within the EU.

Cross-border depositary services

Currently the AIFMD requires that the depositary be located in the same Member State as the AIF. This reduces efficiency and increases costs in jurisdictions with small markets and few service providers.

To remedy the situation, it is proposed to require National Competent Authorities (NCAs) to permit depositary services to be provided in another Member State until such time as the introduction of a depositary passport is considered. To improve supervision in these cases depositaries will have to cooperate not only with their NCAs but also with those of the AIF appointing them and those of the AIFM that manages it. In the case of depositaries from third countries, those domiciled in high-risk jurisdictions according to the regulations against money laundering or in non-cooperative jurisdictions in tax matters are excluded.

Information to investors

It is proposed to include the following in pre-contractual information: 1) for open-ended AIFs, as part of the description of liquidity risk management, information on the availability and conditions for using liquidity management tools and 2) a list of fees and charges that will be borne by the AIFM or its affiliates. Also, the periodic reporting must include quarterly information on 1) all direct and indirect fees and charges directly or indirectly charged or allocated to the AIF or any of its investments and 2) any parent company, subsidiary or special purpose entity established in relation to the AIF's investments by the AIFM, the staff of the AIFM or the AIFM's direct or indirect affiliates. The portfolio composition of originated loans will also have to be reported periodically.

Marketing under national private placement rules

Non-EU AIFs wishing to be marketed in the EU (regardless of the country of origin of their AIFM) as well as non-EU AIFMs wishing to manage and/or market AIFs in the EU must not be domiciled in a high risk jurisdiction in accordance with the regulations against money laundering or in a jurisdiction included in the list of non-cooperative jurisdictions in tax matters.

Proposals affecting both the AIFMD and the UCITS Directive

Delegation and substance

The different national supervisory practices regarding compliance with the requirements for the delegation of risk or portfolio management create inconsistencies that may undermine investor protection, especially when delegation is to non-EU third parties.

In order to provide more clarity to the regulation, additional measures are included to ensure that managers have the appropriate technical and human resources to carry out their activities and supervise the delegations and are required to describe them in detail when applying for authorisation. The manager must have at least two persons resident in the EU employed by it or dedicated to it full time, thus ensuring that the manager maintains a minimum stable substance.

In addition, where an entity delegates more risk or portfolio management functions to non-EU entities than it retains, it is proposed that NCAs be obliged to report such delegation agreements annually to the European Securities and Markets Authority (ESMA). It is proposed to empower ESMA to develop regulatory technical standards for these notifications. ESMA will also be required to present to the European co-legislators and to the EC every two years reports analysing market practices on delegation, compliance with legal requirements and supervisory convergence in this area. Finally, ESMA must carry out, at least every two years, peer reviews on supervisory practices in relation to delegation with special attention to preventing the creation of so-called letter-box entities.

It is also clarified that the delegation regime applies to all functions relating to the core management activity of AIFs and UCITS and also to the ancillary services permitted under the Directives.

Additionally, to align the UCITS regime with that of the AIFMD (1) it is proposed that UCITS managers be required to justify their delegation structure based on objective reasons and (2) the EC is empowered to adopt delegated acts specifying the conditions for delegation and the conditions under which the AIFM/UCITS management company may be considered a letter-box entity.

Liquidity management

There is currently no harmonised minimum set of liquidity management tools. This divergence limits the effectiveness of a possible response by open-ended fund managers or supervisors in situations of market stress.

This amendment is intended to allow managers of open-ended UCITS and AIFs to use the necessary liquidity management tools in exceptional circumstances. In addition to the suspension of redemptions, it is proposed to require managers to choose at least one other tool from among those included in a new annex (one for each Directive), which includes a minimum harmonised list[1]. Member States must ensure that at least these tools are available in their jurisdiction. In order for investors to make informed decisions, they must be informed of the conditions for the use of these tools. The managers must notify their NCAs of their activation and deactivation. ESMA must develop regulatory technical standards specifying the characteristics of the tools in the annex as well as the process for managers to select and use them.

To ensure investor protection and financial stability, NCAs may require a manager to activate or deactivate the relevant tools, and this includes managers from outside the EU. NCAs will notify other relevant authorities, ESMA and the European Systemic Risk Board (ESRB) before requesting the activation or deactivation of a tool (cooperation principles are included in these cases). ESMA must develop regulatory technical standards indicating the circumstances in which NCAs would be able to intervene in this way.

Supervisory reporting

In the case of AIFMs, the aim is to improve the collection of relevant data and eliminate unnecessary duplication. For the former, the limitations on the information that NCAs receive from AIFMs, which currently focuses on the main markets and instruments in which they trade as well as the main exposures or counterparties of the AIFs they manage, must be removed. Although reporting requirements must be analysed, the rules must be less restrictive to allow new data to be requested if it is considered appropriate. ESMA must develop a proposal for technical standards to replace the current reporting model and establish the new detailed reporting requirements.

For UCITS managers, it is proposed to introduce an obligation to report periodically for supervisory purposes on instruments and markets in which they trade on behalf of the UCITS. ESMA is also empowered to analyse reporting requirements in cooperation with the European Supervisory Authorities and the European Central Bank and to propose a standardised reporting model for UCITS managers. ESMA will have to develop technical standards based on its conclusions from this analysis.

Custody

Central securities depositories (CSDs) are not currently considered delegates of the depositaries, and this legal situation means that the stable flow of information between the two is not always assured.

To remedy this, it is proposed to subject CSDs to the rules for delegation of custody. In addition, it is proposed that when the custodian is a CSD, the depositaries should not have to perform ex-ante due diligence since these entities will have been sufficiently vetted when seeking to be authorised as such.

Supervisory cooperation

Supervisory cooperation is reinforced; the NCA of the AIFM's host Member State may request the home NCA to exercise its supervisory powers based on a reasoned request and notifying ESMA and the ESRB (when there is a risk to financial stability). The burden of proof for NCAs is reduced (previously they had to provide clear and demonstrable reasons). ESMA is empowered to ask NCAs to present to ESMA cases that may have cross-border implications or an impact on financial stability or investor protection, and its analysis of these cases is expected to help prevent similar cases in the future.

[1] The annexes for both UCITS and AIFs include the following tools: 1) Suspension of redemptions and subscriptions. 2) Redemption gates. 3) Notice periods. 4) Redemption fees. 5) Swing pricing. 6) Anti-dilution levies. 7) Redemptions in kind 8) Side pockets.

Useful link:

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