

AIFMD II Makes Rapid Headway as Commission Makes Final Compromise Text Available

29 November 2023

On 13 November 2023, the European Commission (the “Commission”) published the final compromise text amending AIFMD (“AIFMD II”). The publication of the text of AIFMD II signifies the conclusion of the technical dialogue and consultations between the Commission, the Council of the European Union and the Parliament. The original draft proposal for AIFMD II was published by the Commission on 25 November 2021 (the “Original Draft”), with political agreement being reached on 20 July 2023.

The most notable change is the introduction of a pan-European loan origination regime for alternative investment fund managers (“AIFMs”) and the alternative investment funds (“AIFs”) they manage. Despite the new requirements, it is helpful that AIFMD now expressly permits loan origination as an investment activity of an EU AIFM.

AIFMD II brings a handful of other changes, such as minor amendments to the current authorisation process, changes to the delegation provisions and further work for a depositary passport.

As a next step, AIFMD II is expected to be approved by the Member States before it is formally adopted. We anticipate that AIFMD II will be published in the Official Journal by the end of the first quarter of 2024. Member States then have two years to transpose AIFMD II into national laws.

We have summarised below the most relevant changes of the new regime and highlighted specifically where the final text departs from what has been discussed in previous versions.

Loan Origination

After several years of regulatory uncertainty, AIFMD II addresses loan-originating funds (“LOFs”) by introducing different sets of rules that apply at the level of the AIFM and at the level of the LOF (including each loan originated by the LOF).

AIFMD II introduces two new key definitions:

- “loan origination” where: (i) an AIF either directly or indirectly (including through a third-party or special purpose vehicle) originates a loan on behalf of the AIF or AIFM, and (ii) the AIFM or AIF is involved in the structuring of the loan, including defining or pre-agreeing its characteristics. The clarification in respect of “indirect” loan origination through other entities is a welcome clarification, as the status quo sees different approaches in this respect in different Member States.
- A “loan-originating AIF” will qualify as such if it meets any one of the two conditions:
 - an AIF whose investment strategy is mainly loan origination; or
 - an AIF where the originated loans represent at least 50% of its net asset value.

AIFM-Level Requirements

Policies, Procedures and Processes

AIFMD II will require AIFMs that intend to engage in loan origination to implement policies, procedures and processes for providing credit, including to assess credit risk and monitor the portfolio. This reflects the current position in some Member States, such as Luxembourg, where the CSSF introduced similar requirements for AIFMs that engage in loan origination in 2016. Loan origination has been added to the list of optional collective investment management functions in Annex I of AIFMD II, expressly permitting AIFMs to conduct this activity across the European Union.

The requirement to put in place policies, procedures and processes for providing credit will not apply to AIFMs that manage LOFs whose lending activities consist solely of originating shareholder loans where the notional value of such loans does not exceed in aggregate 150% of the AIF’s capital.¹ Shareholder loans are loans that are granted by the AIF to companies in which they hold at least 5% of the capital or voting rights and are “stapled” to (cannot be sold independently of) the other capital instruments held by the AIF. Note that the Original Draft included a derogation for shareholder loans that finance the acquisition of real estate, which is no longer in the final text.

Under AIFMD II, AIFMs must ensure that LOFs are closed-ended. By way of derogation, AIFMs may manage open-ended LOFs where they are able to demonstrate to the relevant national competent authority (“NCA”) that the LOF’s liquidity risk

¹ The term “capital of the AIF” has been defined by AIFMD II as the “aggregate capital contributions and uncalled capital committed to the AIF, calculated on the basis of amounts investible after deduction of all fees, charges and expenses that are directly or indirectly borne by investors”.

management system is compatible with its investment strategy and redemption policy. We expect NCAs to take a pragmatic approach on this point and to request AIFMs that intend to manage open-ended LOFs to demonstrate the appropriateness of their liquidity management system when presenting their general policies, procedures and processes.

AIFMs managing LOFs will need to report periodically on the composition of the “originated loan portfolios” to the investors in such LOF, indicated as detailed information on the portfolio composition.

Restrictions at the Level of the LOF

- **Leverage cap.** LOFs will be subject to limitations on the use of leverage. This restriction has undergone significant revisions from the Original Draft. AIFMD II specifies leverage caps for LOFs for both open-ended and closed-ended LOFs, with a cap of (i) 175% for an open-ended LOF and (ii) 300% for a closed-ended LOF. This ratio is calculated on the basis of the fund’s exposure, divided by net asset value, using the commitment methodology. Borrowings that are fully covered by commitments from investors of the LOF (directed at subscription line facilities) are not considered exposure for the purpose of the caps.² The caps do not apply to a fund whose lending activities consist solely of originating shareholder loans, provided that the notional value of those loans does not exceed in aggregate 150% of the fund’s capital.
- **Restrictions on borrowers.** LOFs are not permitted to grant loans to the AIFM, the staff of the AIFM, its depositary, its delegates or a group entity of the AIFM.
- **Restrictions on lending to consumers.** Under AIFMD II, Member States may prohibit LOFs from granting loans or servicing credits to consumers. Where Member States prohibit lending by LOFs to consumers in their territory, this does not affect the marketing in the European Union of AIFs granting loans or servicing credits granted to consumers in other Member States.

² In an earlier version, the Commission proposed a lower cap of (i) 150% for open-ended LOFs and (ii) 250% for closed-ended LOFs calculated using the commitment methodology (for AIFs that also invest in derivatives other than for hedging purposes). Where AIFs do not invest in derivatives (unless for hedging), the proposed leverage cap was: (i) 50% for open-ended LOFs and (ii) 200% for closed-ended LOFs calculated using the borrowing methodology. This is viewed as a critical win for PE managers since we believe that this will provide managers with additional flexibility with respect to the use of leverage.

- **Prohibition of “originate-to-distribute” strategies.** AIFMs are not permitted to manage LOFs whose sole purpose is to transfer those loans or exposures to third parties.
- **Risk diversification.** Lending to a single borrower that is a financial undertaking (such as a credit institution, an insurance undertaking or an investment firm), an AIF or a UCITS is limited to 20% of the AIF’s capital. This is to reduce systemic risk for the financial system. This restriction applies from the date specified in the LOF’s constitutional document, so long as such date is no later than two years from the date of the first closing. This restriction: (i) ceases to apply once the assets of the LOFs are sold, in view of the LOF’s liquidation; and (ii) may be temporary suspended when the capital of the LOF is increased or decreased.
- **Retention requirements.** As a new risk-retention requirement, a LOF will be required to retain at least 5% of the notional value of each loan it originates and is subsequently sold on the secondary market. The recitals of AIFMD II explain that this is to “avert moral hazard and maintain the general credit quality of loans originated by AIFs”.

The applicable retention period is determined in two ways:

- loans with a maturity up to eight years, where 5% of the notional value must be retained until maturity; and
- loans with a maturity longer than eight years, where 5% of the notional value must be retained for a period of at least eight years.

There is a list of exemptions where the risk retention rules do not apply:

- the sale of assets of the AIF as part of the AIF’s liquidation;
- the disposal of assets to comply with EU regulations or product requirements;
- the sale of assets to implement the AIF’s investment strategy in the best interests of the AIF’s investors; and
- the sale of assets due to a deterioration in the risk associated with the loan, in accordance with the AIFM’s risk management process for the AIF. The AIFM will need to determine what amounts to deterioration in the risk associated with the loan for this purpose.

Transitional Provisions and Grandfathering

The new LOF regime will generally apply as at the end of the AIFMD transposition period, which is 24 months after the date of entry into force of AIFMD II (the “Transposition Date”). Where an AIFM becomes the manager of a LOF established on, or after, the Transposition Date, it will comply with all new requirements.

The transitional rules contain certain reliefs with respect to LOFs that are in existence as at the Transposition Date. Those rules depend on whether the relevant LOF is still in fundraising:

- For existing LOFs that are no longer in fundraising, AIFMs will be exempt from complying with (a) the diversification rules in respect of a single financial borrower and (b) the liquidity risk management requirements for open-ended funds.
- For LOFs that are still in fundraising, AIFMs will have a grace period of five years from the Transposition Date with respect to (a) the diversification rules in respect of a single financial borrower, (b) the leverage caps and (c) the liquidity risk management requirements for open-ended funds. However, with respect to diversification and leverage, if those limits are already exceeded on the Transposition Date, the respective LOF is no longer permitted to increase the respective exposure. Where such limits are not yet reached on the Transposition Date, these AIFMs are required not to exceed the respective limits.

AIFMs managing existing LOFs can choose to comply voluntarily with the restrictions above so long as they notify their NCA.

Finally, the rules contain exemptions from certain new requirements that apply at the level of a loan (such as no lending to non-eligible borrowers, restrictions on consumer loans, prohibition on “originate-to-distribute” and risk retention) that will not apply to loans that were granted prior to the Transposition Date but only with respect to those existing loans.

Delegation

The changes to the delegation regime are less impactful than initially expected. Delegation arrangements, where the delegate is regarded as performing more functions than the AIFM, have long been an area of concern for ESMA and the Commission. “White-label” solutions were also put under scrutiny, in particular by ESMA in the context of relocations triggered by Brexit.

In terms of data collection, an AIFM will be required to provide its NCA, as part of its regular reporting, with a new set of information on the delegation arrangements concerning portfolio management or risk management functions.

AIFMD II provides a definition of a host AIFM, which is an AIFM that “manages or intends 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”. AIFMD II does not prohibit the use of host AIFMs but requires them to provide to their competent authority information on reasonable steps they have taken to prevent, manage and monitor conflicts of interest arising from the relationship, as applicable.

Under AIFMD II, there is a new provision that AIFMs must ensure that performance of the delegated functions and/or services complies with the requirements set out in the AIFMD, irrespective of the regulatory status or location of any delegate or sub-delegate. This provision has been subject to some controversy during the legislative process. Whilst it could be read to require a delegate to comply with all requirements under AIFMD (an extra-territorial application of European Union law which is obviously problematic for non-EU-based delegated portfolio managers, often subject to other regulatory requirements that might contradict AIFMD specific requirements), in our view, this statement only reiterates the current requirement that a delegation may not lead to undermining or a circumvention of AIFMD rules and standards when it comes to the actual performance that a delegate performs on behalf of an AIFM.

AIFMD II clarifies that marketing activities by distributors acting on their own behalf will not be considered to be delegation by the AIFM even if a distribution agreement exists between the AIFM and the distributor.

Noting a significant deviation from the Original Draft and certain subsequent versions, the final text of AIFMD II no longer requires the Commission to set out conditions under which the AIFM has become a letter-box entity by virtue of delegating all of its functions and services. We see this as a compromise in favour of AIFMs.

Broadened Scope of Permitted Activities for AIFMs

AIFMs are currently prohibited from carrying out any activities other than those for which they are authorised. The current text of AIFMD permits AIFMs to manage AIFs and to obtain an additional authorisation to manage UCITS and to provide MiFID services comprising of discretionary portfolio management, investment advice and safe-keeping services in relation to fund units or shares as well as reception and transmission

of orders (“RTO”) services (the so called “MiFID top-up”). An AIFM may not perform other regulated or unregulated activities.

AIFMD II now permits AIFMs also to provide “any other function or activity” that they already provide while managing an AIF. This is an important step away from a regime that was often felt to be too restrictive and did not create a level playing field with other financial institutions, such as MiFID investment firms or credit institutions. To engage in those ancillary activities, the AIFM will need to appropriately manage any conflicts of interest that arise.

In respect of the MiFID top-up, AIFMs are no longer required to always apply for an authorisation for discretionary portfolio management in order to obtain a license to provide investment advice, safe-keeping services and RTO services. These licenses are therefore accessible on a standalone basis. This is welcome, as this was a strategic disadvantage for AIFMs in comparison to MiFID firms.

Additionally, AIFMs can also be involved in credit servicing and administration of benchmarks.

Other Changes

- **Assessments of costs.** As part of the disclosures made to its investors under Article 23 of AIFMD, the AIFM is required to disclose a detailed list of all fees, charges and expenses that are either directly or indirectly allocated to the AIF and ultimately borne by the investors. ESMA is required to prepare a report to the Commission in this respect. We believe that this is the first step towards the implementation of a framework on undue costs and transparency surrounding costs charged to retail investors under the upcoming Retail Investor Strategy (for more information you may refer to our update [here](#)).
- **Cross-border appointment of depositaries.** Under AIFMD II, NCAs may permit AIFMs to appoint depositaries in Member States other than the home Member States of the AIF. Note that this does not amount to a depositary “passport” and is subject to certain conditions, such as (i) lack of an effective depositary service in the home Member State of the AIF and (ii) the national depositary market of the home Member State of the AIF not exceeding €50 billion.
- **Appointment of independent directors.** With a view of enhancing investor protection, a recital to AIFMD II proposes that where AIFs are marketed to retail investors, it is “appropriate to encourage” AIFMs to appoint at least one independent

director or non-executive director (“NED”). However, there is no specific provision in the main body of the final text that calls for the appointment of an independent director or a NED for AIFs that target retail investors. The feasibility of including a provision addressing this will be part of the AIFMD II review in five years.

- **Additional information to be provided during application process.** As part of its application process, an AIFM applying for authorisation should provide the relevant NCA with information on the persons managing the AIFM. AIFMD II now specifies the kind of information AIFMs will have to divulge. This relates to the role, title and level of seniority of the management; their respective reporting lines and responsibility (both within the AIFM and outside the AIFM); the time allocated by the management to their respective responsibilities; and technical and human resources that assist the management in the performance of their activities. The AIFM is also required to provide information on the compliance of SFDR, particularly, the consideration of sustainability risks in its investment decision-making process and its remuneration policies.
- **Misleading fund names.** Within two years from the adoption of AIFMD II, ESMA is mandated to provide guidelines specifying situations where the name of the AIF is “unfair, unclear, or misleading” to investors. AIFMD II specifically requires the name to be included in the AIFMD Article 23 disclosure document (which is common practice already). In this context and to further investor protection, we anticipate that the Commission and the ESAs will continue to provide guidelines and “hard law” to counter the risks of greenwashing. We believe that these guidelines will serve as a blueprint for naming AIFs (you may also refer to our update [here](#) for more information).
- **Harmonisation of reporting processes.** AIFMD II contains various recitals and provisions aiming at creating a higher level of harmonisation of the reporting processes for AIFMs. There is still a lot of work to be done at Commission and ESMA level in the form of delegated regulations (e.g., to replace the existing reporting templates in Commission Delegated Regulation (EU) No. 231/2013, which will also address the reporting frequency and the timing), regulatory technical standards (“RTS”) and other regulatory tools. With respect to ESMA preparing RTS for reporting delegated arrangements, the Commission has laid down the proverbial redline to ensure that the RTS will be limited only to standardising the information to be reported.

We will keep you posted about further changes surrounding AIFMD and the legislative process as they arise.

Please do not hesitate to contact us with any questions.



Patricia Volhard
Partner, London
+44 20 7786 5505
pvolhard@debevoise.com



Christopher Dortschy
Partner, Luxembourg
+352 28 57 95 3322
cdortschy@debevoise.com



Jin-Hyuk Jang
International Counsel,
Frankfurt
+49 69 2097 5115
jhjang@debevoise.com



John Young
International Counsel, London
+44 20 7786 5459
jyoung@debevoise.com



Mathieu Voos
Associate, Luxembourg
+352 28 57 95 3321
mvoos@debevoise.com



Eike Björn Weidner
Associate, Frankfurt
+49 69 2097 5220
ebweidner@debevoise.com



Keith Moshe
Corporate Staff Attorney,
Frankfurt
+49 69 2097 5123
kmoshe@debevoise.com