European Commission’s Proposals for reform of AIFMD, UCITS Directive and the ELTIF regime

Welcome changes or regulatory creep?

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Following its review of the scope and functioning of the Alternative Investment Funds Manager Directive\(^1\) (AIFMD), the European Commission (the Commission) has concluded that the AIFMD’s standards for ensuring high levels of investor protection are mostly effective, but that amendments are required which are intended to be targeted in scope, but may have far-reaching effects.

The Commission has now published new legislative amendments to AIFMD, the UCITS Directive\(^2\) (UCITSD) and the ELTIF Regulation\(^3\) (ELTIF Regulation) (the Commission Proposals). The proposed amendments set out in the Commission Proposals will be introduced by way of an omnibus directive amending the AIFMD, UCITSD and the ELTIF Regulation.\(^4\)

Key Takeaways

Key changes are proposed to both AIFMD and UCITSD will include:

- Delegation requirements, including applying delegation rules to core and ancillary regulated activities; the imposition of minimum substance requirements to harmonise requirements across the EU; harmonising the
UCITSD requirements with the AIFMD regime; and bi-annual peer reviews by ESMA of delegation arrangements to third country entities;

- A minimum list of liquidity management tools for managers to use where required and for regulators to apply, including in respect of non-EU AIFMs;
- Increased data reporting for market monitoring purposes; and
- Amendments to the regulatory treatment of custodians, in particular, bringing central securities depositories (CSDs) into the custody chain.

Key changes specific to AIFMD will include:

- New requirements for loan-originating / direct lending AIFs including eligibility, conduct and reporting requirement.
- Improved access arrangements for depositary services across borders (however, the depositary passport has not yet been implemented).

Key changes to ELTIF Regulations will include:

- Relaxation of rules relating to eligible assets for ELTIF products, which will no longer need to be in the EU.
- Relaxation of marketing restrictions for ELTIFs to ensure that these products have greater marketability amongst professional and retail investors.

An in-depth coverage of the proposed legislative amendments included as part of the Commission Proposals are set out below.

**Our Insights**

The Commission has identified three key drivers giving rise to the need to review the AIFMD, namely:

1. incomplete or inefficient regulation (e.g. fragmented rules on and availability of liquidity management tools, differing national requirements for loan originating funds and different regulatory treatment of custodians);
2. market developments (e.g. growth in AIFMs managing loan origination funds, liquidity mismatches);
3. inconsistent application of rules in EU Member States, with particular regard to the delegation regime.

The Commission is of the view that these drivers have given rise to difficulties in monitoring and managing financial stability risks; inefficiencies in managing investment funds; and inadequate protection of fund investors, which it has sought to address through these new proposals.

The European asset management industry has grown significantly since 2008 (from EUR 5.5 trillion of assets under management assets to over EUR 15 trillion\(^5\) in assets under management). Therefore, macro prudential oversight of EU investment funds, together with the wider systemic risk debate (given the interconnectedness of investment funds and asset management with the broader financial sector) feature prominently in the Commission Proposals, as expected and liquidity risk management is front and centre in the new reforms.

The Commission Proposals seek to implement targeted amendments, but some are far reaching and the overall scope is wide. Key amendments to both AIFMD and UCITSD, in relation to delegation, liquidity risk management, data reporting for market monitoring purposes and regulatory treatment of custodians are indicative of a move towards rule alignment and a single investment funds rulebook to “support fund market integration”.

While delegation rules were recognised as “robust”, the new requirements in relation to delegation are more extensive and onerous for AIFMs, and will also be extended to the UCITS regime. Significantly, and going far beyond initial discussions and feedback, the Commission Proposals seek to implement transaction reporting for financial instruments and transparency on costs and fees, akin to MiFID\(^6\) type requirements.

It is also interesting to note what reforms are not addressed within the Commission Proposals, including the lack of an AIFMD passport for sub-threshold AIFMs and the introduction of a depositary passport (although there appears to be movement in that direction in the longer term). Significantly, no changes are proposed to remuneration rules or leverage...
calculation methodology requirements. The non-listed companies’ rules, although noted as not adding any value in the AIFMD review process by DG FISMA, were not amended.

Timing and steps

EU Member States will have 24 months after the entry into force of the amending omnibus directive, which is expected in early 2023, to transpose the legislation and new requirements into national legislation, meaning that the legislative changes are expected to take effect in early 2025. In the interim, the Commission Proposals will be subject to the ordinary legislative review process at European level and ESMA will be expected to conduct a significant proportion of its legislative drafting during this period.

Summary of key changes to AIFMD and UCITS rules

A high level summary in relation to certain key changes proposed to the AIFMD and the UCITSD are set out below:

Liquidity Risk Management (UCITS & AIFs)

Liquidity risk management is centre stage in this review, which was to be expected given previous liquidity issues in investment funds (e.g. 2008 financial crisis, property funds, COVID). As well as proposed changes to the rules for loan origination funds (detailed below), the rules on availability and use of liquidity management tools (LMTs) by AIFMs and UCITS management companies are to be harmonised to ensure that any response by AIFMs and UCITS management companies of open-ended AIFs/UCITS or by EU regulators in market stress situations can be more effective and ensures fair treatment of investors. At present, neither the existing AIFMD or UCITSD provide for a harmonised set of LMTs.

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<tr>
<th>Changes to Liquidity Risk Management Framework</th>
<th>Minimum List of LMTs</th>
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<td>Minimum list of LMTs developed to harmonise LMTs at the EU level. These include suspension of redemption and subscriptions, gates, notice periods, redemption fees, swing pricing, anti-dilution levies, redemption in kind and side pockets. AIFMs and UCITS management companies must incorporate at least one LMT from the defined list in the fund’s constitutional document.</td>
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<td>ESMA is tasked with developing draft regulatory technical standards to provide definitions and specify the characteristics of the LMTs.</td>
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<td>Usage of LMTs</td>
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<td>AIFMs and UCITS management companies of open-ended funds will be able to suspend the repurchase or redemption of AIF or UCITS units or shares temporarily in situations of market stress. AIFMs and UCITS management companies will also be required to choose at least one other liquidity management tool, without imposing which one, which they could activate should circumstances so require.</td>
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AIFMs and UCITS management companies must implement detailed policies and procedures for the activation and deactivation of any LMT and the operational and administrative arrangements for the use of LMTs.

Regulatory Notifications

AIFMs and UCITS management companies will be required to notify EU regulators about the activation or deactivation of an LMT. EU regulators may be granted the power to step in and require AIFMs and UCITS management companies (including non-EU AIFMs) to activate or deactivate a relevant LMT.

Disclosures to investors

AIFMs will be required to disclose to investors under Art. 23 the conditions for using LMTs.

Delegation and substance framework (UCITS & AIFs)

The review of the AIFMD aims at, inter alia, better protecting investor interests by ensuring that the investment fund managers, when delegating their functions to third parties, adhere to the same high standards applicable across the EU. In such a context, the Commission proposes that sufficient human resources are deployed to supervise the delegate as well as ensuring that the core functions are retained by the AIF or UCITS manager.

Changes to Delegation and substance Framework

Ancillary services

To increase efficiency of AIFM activities, the list of ancillary services that AIFMs could provide in addition to collective asset management has been broadened to include activities permitted by other EU laws, such as benchmark administration and credit servicing.

Delegation of portfolio management or risk management functions towards a more coherent approach

The new rules aim to address different supervisory practices (called “different understandings”) across the EU for delegation of the two key core functions of an AIFM, namely risk management and portfolio management, in particular when delegating these functions outside the European Union (Brexit context but also US). The amendments aim at improving investor protection, considered to be undermined by gaps that may be created by divergent interpretation of the legal
requirements for fund managers delegating their functions to third country entities, as well by the diverging national supervisory practices, which could also harm trust in the market.

It is acknowledged that AIFMs/management company of UCITS may delegate more portfolio management or risk management functions than they retain. Although there is no indication as to the minimum proportion of activities they must retain, the delegation arrangements notification form (the content of which will be developed by ESMA) must contain data fields indicating the activities making up the risk and portfolio management functions. This is in order to permit regulators to determine whether an AIFM/management company of UCITS has delegated more of such functions than it has retained. In such a context, more stringent requirements - in terms of reporting to the competent authorities - are set out should the AIFM/UCITS management company delegate said activities to third country entities.

Sub-delegation to non-authorised entities has been precluded; however further clarification will be required in this regard due to misalignment in terminology in the draft proposals.

For alignment with AIFMD requirements, **UCITS management companies shall be required to justify its entire delegation structure based on objective reasons.**

**Delegation arrangements** apply to all functions listed in Annex I of the AIFMD/Annex II of the UCITSD and to the ancillary “top-up” services permitted under Article 6 (4) of the AIFMD/Article 6 (3) of the UCITSD. Therefore, if implemented, the debate of outsourcing versus delegation will no longer be relevant for such services.

In order to map out delegation practices at EU level, **ESMA should be notified of delegation arrangements by home regulators where more risk or portfolio management is delegated to third-country entities than is retained.**

To ensure consistent harmonisation of the notification process in the area of delegation, the **Commission** shall adopt:

- based on ESMA’s draft regulatory technical standards, a delegated act prescribing content, forms and procedures for the transmission of delegation notifications;
- a delegated act specifying the conditions for delegation and the conditions under which the AIFM/UCITS management company shall be qualified as a letter-box entity.

**ESMA** is entitled with new extended powers in relation to delegation. It is required to:

- carry out peer reviews of the competent authorities in relation to delegation at least every two years, with a particular focus on preventing the creation of so-called letter box entities when AIFMs and UCITS management companies delegate portfolio or risk management to third country entities;
- present the EU co-legislators and the Commission with regular reports (at least every two years) analysing market practices regarding delegation, compliance with the requirements applicable to delegation under the AIFMD and supervisory convergence in this area.

The Commission is required to complete a review of the delegation regime within five years of the
implementation of the new requirements, taking into account advice from ESMA on the effectiveness of the regime.

Human and technical resources

To ensure appropriateness, when applying for authorization the AIFM/management company of UCITS should also include a detailed description of the human and technical resources which it will employ to carry out its functions and to supervise the delegate.

The foregoing is further corroborated by a requirement that the AIFM/UCITS management company employs or commits, on a full time basis, at least two natural persons who are resident in EU.

Loan Origination / Direct Lending Funds (AIFs Only)

As mentioned above, liquidity management is at the core of the Commission Proposals. In this regard, the Commission Proposals introduce harmonised requirements at EU level for AIFMs managing loan-originating AIFs in order to promote sound processes for loan origination/direct lending by AIFs and to further market integration in this segment, while ensuring that the risks to the financial stability are better monitored overall. The Commission Proposals do not include a definition of what constitutes “loan origination”. However, importantly a distinction is drawn between the granting of loans and loan purchasing. in addition, it is not envisaged that there shall be grandfathering provisions for existing direct lending structures.

Changes to Loan Origination Framework

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<tr>
<th>Policies, Procedures and Processes</th>
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<td>AIFMs managing AIFs, which grant loans, will be required to implement effective policies, procedures and processes for the granting of loans, including a credit risk assessment, and to administer and monitor their credit portfolios, which should be reviewed annually. This also covers the activity of purchasing loans on the secondary market.</td>
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Liquidity, Lending and Investment Restrictions

| AIFs must adopt a closed-ended structure where they engage in loan origination to a significant extent (More than 60% of NAV). |
| Where a borrower is a financial institution or an AIF or a UCITS, AIFMs must comply with exposure limits to diversify their risk (AIFM must ensure that a loan originated to any single borrower by the AIF it manages remains below 20% of the AIF’s capital). |
| Annex I of AIFMD has been amended to recognize lending as a legitimate activity of AIFMs (meaning that AIFs will be able to extend loans anywhere in the EU, including cross-border in EU Member States where this activity is not yet permitted). As loan origination is an activity of the AIF rather than the AIFM, the current proposals could give |
Annex I of AIFMD has been amended to legitimise servicing of Securitisation Special Purpose Entities (SSPE) by AIFMs.

To avoid the immediate sale of loans on the secondary market, AIFs will be required to retain an economic interest of 5% of the notional value of the loans they have granted and sold off on an ongoing basis.

Conflicts of Interest

An AIF will be precluded from lending to its AIFM or its staff, its depositary or its delegate.

Reporting

AIFs will be required, as part of Article 23 disclosure rules, to report to investors on their “originated loan portfolios” under the Article 23 disclosure rule.

**Depositories (UCITS and AIFs)**

The Commission’s Proposals seek to dilute depositary market concentration in certain small markets and enhance efficiency by enabling cross-border access to the depositary services “where needed until the time where positive regulatory developments are observed in this area”. The Commission Proposals should lead to an increase in access to depositary services cross border. However this does not yet equate to a depositary passport which was deemed not feasible given the absence of EU harmonisation of securities and insolvency laws.

Key amendments are set out below:

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<th>Changes to rules applicable to Depositories</th>
<th>Cross Border Access to Depositary Services for AIFs</th>
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<td>It is proposed to require EU regulators to permit cross-border access of depositary services for AIFs, where needed, which will facilitate further integration of the EU AIF market, ensuring a high level of investor protection. It is also expected to generate savings for both depositaries and the users of the depositary services, including smaller AIFMs. It is proposed that this approach will be adopted until measures are taken following a further review of the need to introduce a depositary passport is completed.</td>
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<th>Regulatory Treatment of Central Securities Depositories (CSDs)</th>
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<td>Without imposing additional due diligence requirements on depositaries, central securities depositaries (CSDs) will be brought into the custody chain where they are providing competing custody services, thus levelling the playing field among custodians and ensuring that depositaries have access to the information needed to carry out their duties.</td>
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<th>Co-operation with Regulatory Authorities</th>
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Depositaries will be required to cooperate with the home state regulator of both the AIF and AIFM, as well as their own home state regulator.

Marketing under National Private Placement Rules – Articles 36 and 42 (AIFs Only)

It is proposed that AIFMD will be amended to refer to the EU list of non-cooperative jurisdictions as opposed to the previous FATF list of Non-Cooperative Countries.

Significantly, two new requirements are proposed in relation to non-EU AIFs (managed by either an EU or non-EU AIFM) which seek to be marketed in an EU Member State:

- The non-EU AIF may not be domiciled in either: (a) a non-cooperative jurisdiction as defined by the EU Council from a tax perspective;
- The non-EU AIF may not be domiciled in a “high risk country”. 7

Data reporting: towards a new approach to supervisory data (UCITS and AIFs)

The Commission Proposals seek to develop an integrated data collection system to deliver accurate, comparable, and timely data to European and national supervisory authorities, while minimizing reporting costs so that they can support market monitoring, with ESMA developing draft RTS specifying the details to be reported. The new requirements seek to avoid duplication and overlap of reporting requirements applicable to managers, a prominent request from the industry during the AIFMD review process, whilst continuing to rest the requirement for additional reporting with the AIFMs, rather than national supervisory authorities.

In practice, an incremental approach relying on an in-depth feasibility study by supervisors including potential synergies under various EU laws is proposed. However, it is also proposed to “expand data coverage to enable better monitoring of markets”. Amendments to Art 24(1) and (2) of AIFMD to remove limitations on the data that competent authorities should be able to receive from AIFMs on managed AIFs will no doubt be carefully monitored by the industry. ESMA is expected to draft RTS and ITS to replace the current Annex IV AIFMD template on supervisory reporting and to submit to the Commission a report for the development of an integrated supervisory data collection two years after entry into force of the AIFMD.

On the UCITS side, ESMA is expected to produce a report for the development of an integrated supervisory data collection focused on avoiding duplications and inconsistencies and to improve data standardisation and efficient use of data already reported in the EU. This should be done two years after entry into force of the revised UCITSD.

Fees and Charges (AIFs Only)

Significantly and in line with MiFID requirements, the Commission Proposals seek disclosure of fees that will be borne by the AIFM or its affiliates and periodical reporting on all direct and indirect fees and charges that will be directly or indirectly charged or allocated to the AIF or to any of its investments (which will be required to be completed quarterly).

Summary of changes to the ELTIF regulation

The review of the ELTIF Regulation aims at improving the attractiveness of the ELTIF as a fund structure for long-term investments and as a non-bank source of finance to the real economy. The amended framework seeks to reduce regulatory costs for ELTIF managers and to remove barriers access to ELTIF for retail investors (while maintaining the protection currently in force).

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<th>Changes to ELTIF Regulation</th>
<th>Global investment mandate</th>
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<td>To ensure that ELTIFs investment strategies can pursue a global investment mandate, the reference to European-long term projects is no longer included, given that the ELTIF framework explicitly allows the eligible assets and investments to be located in third</td>
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</table>
Real asset definition

The scope of the real asset investment strategies that ELTIF managers can pursue has been broadened, and includes any assets that have intrinsic value due to their substance and properties, and implies that such assets include, infrastructure, intellectual property, vessels, equipment, machinery, aircraft or rolling stock, and immovable property, including rights attached to or associated with real assets, such as water, forest and mineral rights, as well as investments in commercial property, education, counselling, research, sports or development facilities, or housing, such as senior residents or social housing.

Features and limits

ELTIFs can invest in real assets provided that the minimum investment value of such assets is equal to at least Euro 1 million and it is no longer necessary that real assets are owned directly or via “indirect holding via qualifying portfolio undertakings”.

Market capitalisation threshold for listed qualifying portfolio undertakings shall be equal to Euro 1 billion and the market capitalisation threshold is solely applied at the time of the initial investment.

At least 70% of the ELTIF’s portfolio shall be invested in eligible investment assets. Said threshold may be lowered to 50 % for ELTIFs that are marketed solely to professional investors.

An ELTIF may acquire no more than 30% of the units or shares of a single ELTIF, EuVCommissionA, EuSEF, or of an EU AIF managed by an eligible EU AIFM. Concentration limits may not apply where ELTIFs are marketed solely to professional investors.

ELTIF may borrow cash provided that several cumulative conditions are fulfilled having regard to, inter alia, limits to the maximum value of the borrowing vis-à-vis the value of the capital of the ELTIF, the purposes (i.e. it shall serve the purpose of making investments or provide liquidity) and the currency.

An ELTIF shall not invest in an eligible investment asset in which the manager of the ELTIF has or takes a direct or indirect interest, other than by holding units or shares of the ELTIFs, EuSEFs, EuVCommissionAs, UCITS or EU AIFs that it manages.

Co-investments are allowed provided that the ELTIF manager has put in place organisational and administrative arrangements to identify, prevent, manage and monitor conflicts of interest and provided that such conflicts of interest are adequately disclosed.

ELTIFs that can be marketed to retail investors may increase their borrowing of cash up to 50% of the ELTIF threshold, whereas those marketed solely to professional investors would be permitted leverage up to 100% of the ELTIF’s value of the capital.

ELTIF managers can include in the rules or instruments of incorporation of the ELTIF the possibility for an optional liquidity window mechanism.
Specific requirements concerning the distribution and marketing of ELTIFs to retail investors are amended in order to remove unjustified barriers preventing retail investors’ access to ELTIFs.

Authorization procedure

Changes are provided for in order to facilitate the ELTIF authorisation procedure and to clarify, inter alia, that the national competent authority responsible for authorising the ELTIF is solely responsible for its authorisation and is not involved in the additional authorisation or approval of the EU AIFM.

Role of competent authorities and ESMA

The competent national authority shall be informed by the ELTIF managers of the orderly disposal of the assets for the redemption of investors.

Information on authorisations granted or withdrawn and any change of information about ELTIF is communicated by the competent authorities to ESMA, on a monthly basis (rather than on a quarterly basis) and published on a public register held by the latter.

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1 Directive 2011/61/EU.
3 Regulation (EU) 2015/760.
4 Note additional changes are also proposed as part of the Capital Markets Union (CMU) legislative package including amendments to Markets in Financial Instruments Regulation (MiFIR), a proposal for an EU Consolidated Tape and a proposal to establish a European Single Access Point (ESAP) for company financial and sustainability-related data. These additional amendments are not captured as part of this publication.
7 See Directive (EU) 2015/849. Further information available on high risk countries is set out here.

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