Alternative investment funds: Final EU AIFMD 2 text includes transparency rules, lending restrictions

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The European Council recently published the final compromise text of the new Alternative Investment Fund Managers Directive (AIFMD 2), which will significantly alter EU rules governing hedge fund, private equity, and similar firms. It will also amend the Undertakings for Collective Investment in Transferrable Securities Directive (UCITS).

In addition to overhauling its 2011 predecessor, AIFMD 2 is part of the EU's capital markets union legislation and harmonises some rules between the AIFM and UCITS regimes, including around the use of liquidity management tools (LMTs). It makes changes in several areas, but most could be characterised as either increasing transparency or improving prudential protections.

Increasing transparency

Transparency changes start at the point of seeking authorisation, with AIFMs and UCITS management companies (sometimes called "mancos") having to provide more information about the persons operating the business, including their reporting lines, responsibilities, and the support they receive. There must be at least two natural persons, domiciled in the EU, working full-time in the business, either as an employee or a member of the management body.

"AIFMD 2 also introduces new obligations on AIFMs who delegate portfolio or risk management functions, both at the point of authorisation and as part of their regulatory reports," said Neil Robson, partner in the financial markets and funds practice at law firm Katten Muchin Rosenman in London.

Disclosure obligations regarding delegation arrangements are set out in new paragraph article 24(2)(d). Among other things, a firm must provide the following to its relevant national regulator:

- (i) For each delegate, its legal name and relevant identifier, its jurisdiction of establishment, and where relevant, its supervisory authority.
- (ii) A detailed description of the human and technical resources employed by the AIFM for performing day-to-day portfolio or risk management tasks and monitoring delegated activity.
- (iii) In respect of each AIF it manages or intends to manage, a brief description of the delegated portfolio management and risk management functions, including whether such delegation is partial or full.
- (iv) A description of periodic due-diligence measures to be carried out by the AIFM for monitoring delegated activity.

"The European Securities and Markets Authority (ESMA) has been tasked with producing regulatory technical standards (RTS) on the frequency and timings that AIFMs will need to report within 36 months of AIFMD 2 entering into force," Robson said. "How these new requirements will ultimately play out will only become clear once the new RTS on regulatory reporting amends or replaces the current reporting framework."

AIFMD 2's core transparency changes are, however, the increased information to investors under the additional AIFM disclosure obligations introduced by revised Article 23, Robson said.

These disclosure requirements include:

- A description of the AIF's liquidity risk management, including current redemption arrangements with investors and the possibility and conditions of using LMTs selected in accordance with Article 16(2b) AIFMD 2 (described below).
- All direct and indirect fees charged or allocated to the AIF or its investments.
- A list of fees and charges that will be applied in connection with the operation of the AIF and borne by the AIFM or its affiliates.
- The composition of the originated loan portfolio.
- Any parent company, subsidiary, or special purpose entity established by the AIFM in relation to the AIF's investments.

One of AIFMD 2's most profound changes is the introduction of new rules covering all loan origination activity conducted by alternative investment funds (AIFs). The Commission's AIFMD 2 proposal said changes were necessary due to funds' lending activity potentially causing macro-prudential risks that could spread systemically. Several regulators and international bodies, including the Financial Stability Board, have voiced similar concerns.

The new loan origination rules would apply at two levels; one covering all such activity, and the other imposing extra requirements for an AIF that originates loans on a significant basis, making it a "loan originating AIF." To qualify, an AIF would need a lending-based investment strategy or have the notional value of its originated loans represent at least 50% of its net asset value, Robson said.

The universal loan-origination rules concern risk retention, concentration limits, lending restrictions, policies, procedures, and processes.

"AIFs can originate loans and trade-on those loans on a secondary market, subject to a 5% risk-retention requirement, which feels aligned with the EU Securitisation Regulation requirements," Robson said.

"This means that these AIFs must, subject to certain carve-outs, retain 5% of the notional value of each loan they originate and subsequently transfer to third parties."

This 5% must be retained until maturity for loans under eight years or those to consumers, and for at least eight years for all other loans. Additionally, AIFMD 2 would prohibit investment strategies where loans are originated solely to transfer them to third parties.

"AIFMD 2's recitals explain that this restriction has been imposed to 'avert moral hazard and maintain the general credit quality of loans originated by AIFs' – in other words, to avoid situations where loans are originated with the sole purpose of selling them," Robson said.

On concentration limits, AIFMD 2 would impose diversification rules where the borrower is an AIF, UCITS, or financial undertaking within the meaning of Solvency II. The notional value of loans to a single such borrower must not exceed 20% of the AIF's capital, though there are exceptions for some situations.

The lending restrictions would prohibit AIFs from lending to the AIFM, its delegate, the staff of either, or to the depositary or its delegate. Loans could only be made to certain types of member firm in an AIFM group.

Loan-originating AIFs would also face leverage and would have to be closed-ended, meaning one with a fixed number of shares offered through an initial public offering. The final compromise text relaxed the draft's closed-ended requirement by allowing an exception.

"An AIFM wishing to manage an open-ended loan-originating AIF may continue to do so but must 'demonstrate' to its home member-state regulator that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy," Robson said. "For open-ended AIFs, leverage is capped at 175%, while closed-ended AIFs can go up to 300%."

Another major change in AIFMD 2 is new liquidity management rules on the use of LMTs, including extended notice periods, redemption gates, anti-dilution levies, redemptions in kind, and using swing or dual pricing.

AIFMs managing open-ended funds and UCITS management companies would have to select at least two LMTs from a list in AIFMD 2 annex V to be used in exceptional circumstances in the interest of the AIF's investors (new article 16(2b). By way of derogation, only one LMT on the list need be selected if an AIF is an authorised money market fund (MMF) under the MMF Regulation EU 2017/1131.

"The AIFM will also be required to implement detailed policies and procedures for the 'activation' and 'deactivation' of any selected LMTs and set out the operational and administrative arrangements for using any such LMT," Robson said.

"When activating or deactivating an LMT, the AIFM will be under an obligation to notify its home member-state regulator."

These proposals should be seen in the context of ESMA's guidelines on liquidity stress-testing for UCITS and AIFs. The new LMT rules will become a way to ensure liquidity stress-testing is properly integrated in a fund's risk management framework and subject to appropriate governance and oversight.

Conflict requirements

AIFMD 2 would also impose new conflict-of-interest requirements on AIFMs that manage or intend to manage an AIF at the initiative of a third party, including "white label" fund arrangements. The host AIFM would have to send its national regulator an explanation and evidence of how it complies with the article 14 conflicts requirements. This would include showing how it would prevent conflicts from arising and, if they do, how it would identify, manage, monitor, and if necessary, disclose them.

On timing, the European Parliament is scheduled to vote on the final compromise text in early February 2024, with the Council formally approving it thereafter and it being published in the Official Journal. Assuming there are no last-minute surprises, AIFMD 2 would come into force in the spring, with its provisions transposed to national law and taking effect in 2026.

There have been no formal UK AIFMD reform proposals, but the matter appeared in Financial Conduct Authority (FCA) discussion paper DP23/2 on updating the asset management regime. Respondents to that wanted to maintain the core UK AIFMD regime but made it more proportionate and appropriate to the UK market. The FCA has said this will be among the asset management reform priorities.

"In early December 2023, the FCA issued a consultation paper [CP23/28] on 'Updating the Regime for Money Market Funds,' where it made it clear that any wider review to the MMF Regime will follow its 'Smarter Regulatory Framework' reviews for the UK UCITS Directive and the UK AIFMD," Robson said.

"It'll be a case of waiting and seeing what the FCA proposes in 2024."

(Tim Hitchcock, Regulatory Intelligence)