

Alert | Private Funds/Real Estate Funds



December 2023

AIFMD II: New Regulation of Debt Funds and Other Key Changes

In November 2023, after several years of negotiation, the Council of the European Union published the detailed compromise text for the Alternative Investment Fund Managers Directive (AIFMD) II.

While the introduction of the AIFMD a decade ago imposed what were, at the time, substantial changes to the regulation of alternative funds, the AIFMD II text is not so radical and, except for important changes in requirements relating to loan originating AIFs, does not amount to a rewiring of the AIFMD framework.

It is anticipated that the European Parliament will adopt AIFMD II in February 2024. Member states shall transpose the directive into national law within 24 months after its entry into force, while some of the new requirements for loan origination will be applied with delays up until 2029.

New Overarching Loan Origination Requirements

AIFMD II imposes new obligations on AIFs which carry out “*loan origination*”, defined as granting a loan either directly as an original lender or indirectly through a special-purpose vehicle or another party (where the AIFM sets the characteristics of the loan or structures the loan). The new obligations include:

- a requirement that the AIF must retain 5% of a loan for the first eight years of the loan’s maturity. Debt funds following a pure syndication strategy will therefore be practically banned. However, there are

helpful carve-outs where the AIF is being wound down and where the AIFM is selling assets to allow investors to redeem and where the sale is “*in the best interests of the AIF’s investors*”.

- a restriction on lending more than 20% of the AIF’s capital to other AIFs, undertakings for collective investment in transferable securities (UCITS) funds and financial institutions.
- a requirement that an AIF may not lend to the AIFM (or members of the AIFM’s group unless they are a loan originator), the AIFM’s staff and the depositary.
- a requirement to disclose in each relevant AIF’s Article 23 disclosures the full costs and expenses linked to the administration of the loans and to ensure that the proceeds of the loans are remitted to the relevant AIF.
- obligations for AIFMs to have full procedures and systems in place in relation to their loan origination activities and to review those procedures each year.
- rules which prevent AIFMs from originating loans for the sole purpose of then transferring the exposure to third parties.

Specific Extra Requirements for ‘Loan Originating AIFs’

While the above requirements effectively apply to all EU AIFMs of AIFs which are involved in lending, there are extra requirements imposed on what are defined in AIFMD II as “*loan originating AIFs*”. This new definition is an AIF which either:

- (a) has an investment strategy to mainly act as a loan originator; or
- (b) has originated loans which represent at least 50% of its net asset value.

Loan originating AIFs are subject to detailed extra restrictions relating to leverage limits and risk management which are described below:

- (i) **Leverage Limits.** AIFMD II imposes strict limits on the leverage of loan originating AIFs. For open-ended AIFs, leverage is capped at 175%, while closed-ended AIFs can go up to 300%. Leverage, in this context, is defined as the ratio between the exposure of the AIF (calculated according to the commitment method) and its net asset value. Subscription facilities and other “*borrowing arrangements that are fully covered by capital commitments*” shall not be included for the purpose of this calculation. AIFMs managing loan originating AIFs launched before the entry into force of the directive and not raising further capital shall be deemed to comply with these limits, while such AIFMs of existing funds raising more capital are not permitted to increase leverage beyond these limits. For AIFs whose leverage already exceeds the limits, a five-year grandfathering period applies until 2029.
- (ii) **Risk Management.** AIFMs will be required to establish and implement effective policies, procedures, and processes for loan origination. The impact of this regulation is likely to be limited since the majority of AIFMs already have such measures in place for their debt funds. It is worth noting that these obligations do not apply to shareholder loans that do not exceed 150% of the AIF’s capital, which is a concession to AIFMs managing private equity funds.

Preference for Closed-Ended over Open-Ended Loan Originating AIFs

AIFMD II favours closed-ended AIFs for loan origination, as AIFMs “*shall ensure*” that the loan originating AIFs they manage are closed-ended.

An AIFM wishing to manage an open-ended AIF may continue to do so. However, the AIFM needs to “*demonstrate*” to the supervisory authority of its home member state that the AIF’s liquidity risk management system is compatible with its investment strategy and redemption policy. An AIFM managing a loan originating AIF established before the entry into force of AIFMD II only has to comply with this provision five years after the AIFMD II directive enters into force.

Moreover, the European Securities and Markets Authority (ESMA) shall within one year of AIFMD II’s entry into force submit to the Commission draft regulatory technical standards setting out further requirements to be met by an open-ended loan originating AIF. These requirements shall include a sound liquidity management system, the availability of liquid assets and stress testing, as well as an appropriate redemption policy given the liquidity profile of the loan originating AIF, and take due account of the underlying loan exposures, the average repayment time of the loans and the overall granularity and composition of the loan originating AIF’s portfolios. AIFMD II does not contain any grandfathering provisions regarding compliance with these regulatory technical standards.

Open-ended funds are generally required to select appropriate liquidity management tools from a list annexed to the directive, such as suspension of redemption of interest, and inform the supervisory authority of such selection.

It should be recalled that the EU Commission’s original proposal included a ban on open-ended pure debt funds. The compromises now introduced are minor compared to this original proposal. However, it remains to be seen how burdensome the technical standards yet to be developed by ESMA will be.

Other Key Changes Affecting the Alternative Investment Fund Industry

In addition to the provisions addressing specifically loan originating funds, AIFMD II introduces several other notable changes that will impact the alternative investment industry as a whole:

- AIFMD II addresses **delegation**. It explicitly states that delegation rules only apply to activities for which AIFMs require authorisation (i.e. investment management, other functions listed in Annex I of the AIFMD, as well as ancillary services) and emphasises the need for AIFMs to ensure their delegates comply with the AIFMD. Critically AIFMD II does not (as had been originally feared) prevent delegation of portfolio management by European AIFMs to third country managers; however, EU AIFMs will have to provide more detail to their local regulators about all delegation.
- **Depositary requirements** for EU AIFs have been modified under AIFMD II. Depositaries may now be located in EU member states other than the AIF’s home member state, but only under strict conditions. These conditions include the absence of a suitable depositary in the AIF’s home member state, the lack of a significant market for depositary services in the home member state, and a supervisory assessment of such lack of relevant depositary services in the home member state.
- **Fund names**. ESMA will be mandated to develop guidelines on **permissible names** of AIFs to enhance transparency for investors. Names of AIFs must not be “*unfair, unclear, or misleading*”.
- **Reporting to supervisors** will become more rigorous under AIFMD II. AIFMs are now required to report on all markets, instruments, and exposures of their AIFs, going beyond the previous scope.

Detailed new reporting requirements relate to the delegation of portfolio management or risk management functions and the reporting of where the AIFs are actively marketed. How these new requirements will ultimately play out will only become clear once a new set of regulatory technical standards on regulatory reporting amends or replaces the current reporting framework.

- **National Private Placement Regime (NPPR) Marketing into Europe.** AIFs from jurisdictions identified as high risk under the EU's AML Directive (which the Cayman Islands was on for a short time in 2022) will not be able to be marketed into the EU unless that jurisdiction has entered into a separate agreement with each EU jurisdiction into which the AIF is being marketed.
- **Conflicts management requirements for third-party AIFMs.** Third-party AIFMs will need to submit detailed information to their local regulators as to how they manage conflicts between their AIFs.

It is also important to note only the NPPR changes impact UK AIFMs. While the UK's AIFM regime will be subject to review during the course of 2024, it is not anticipated that the UK's version of the AIFMD will be amended to follow AIFMD II.

In summary, AIFMD II introduces significant changes for loan originating funds in particular and more manageable changes for the alternative investment fund industry as a whole. AIFMs should review and adapt their operational and compliance procedures to meet the new requirements.

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