

# AIFMD II: Five key changes for closed ended managers

On 25 November 2021, the European Commission published draft amendment text in connection with the Alternative Investment Fund Managers Directive (2011/61/EU; “AIFMD”).

In the preamble to the draft text, the Commission acknowledged that the existing ‘...AIFMD standards for ensuring high levels of investor protection are mostly effective’ and that ‘...AIFMD is generally meeting its objectives...’ and this sets the tone for the scope of the proposed changes, none of which are seismic in nature. Notwithstanding this, most changes will cause a degree of uncertainty and, in this article, we focus on what we view as the five key changes impacting closed ended managers:

## 1. Delegation:

AIFMD II amends Articles 7 and 20 of AIFMD and introduces the following requirements:

- at the point of authorisation, competent authorities will be required to assess whether an AIFM delegates more portfolio management or risk management functions to entities located in third countries than it retains and will be required to report to ESMA annually on any entities that are identified under this provision; and
- an AIFM applying for authorisation will be required to provide a detailed description of the human and technical resources to be used by the AIFM for monitoring and controlling any delegation of functions covered under Article 20.

ESMA has been charged with providing regular reports (at least every two years) to the Council and Parliament regarding delegation to entities located in third countries and, under new Article 38a, must conduct a peer review analysis of the supervisory activities of the competent authorities in relation to the application of Article 20 at least every two years, in order to prevent AIFMs that delegate portfolio and/or risk management to parties located in third countries from becoming letter box entities. Regulatory technical standards are expected in

connection with the reporting process.

No information has yet been provided on how a competent authority is expected to make the assessment detailed under (a) above, whether delegation of portfolio and risk management should be looked at collectively or individually, and it is not currently clear what impact this will have in the context of existing delegation arrangements (in particular as between third party AIFMs and UK (or other third country) sponsors where portfolio management is often delegated almost in its entirety).

In the original text of AIFMD, Recital 31 made it clear that the delegation rules should only be applied in connection with the delegation of management functions set out in Annex I of AIFMD, being portfolio management and risk management ("**Core Functions**"). The starting point with delegation under AIFMD therefore, was that the rules were only applicable when Core Functions were delegated. By November 2016, ESMA had updated its AIFMD Q&A to cut across this position suggesting that all functions listed in Annex I were subject to the delegation rules, which includes some of the more prosaic tasks such as record keeping, accounting, regulatory compliance monitoring and so on ("**Ancillary Functions**").

Proposed amendments in AIFMD II cement this position with an amendment to Article 20, sweeping all of the functions listed in Annex I, together with the services referred to in Article 6(4), into the substantive delegation rules. Depending on how competent authorities have interpreted AIFMD to date, this could have a meaningful impact on the authorisation process and also on the ongoing supervision of delegates, increasing cost and administration in this area.

In one sense the changes to the delegation rules are not too significant; it's noteworthy that the proposals are not looking to limit third country delegation for example, just ensure that it's recorded and monitored. Having said this, the concrete extension of these rules to Ancillary Functions is concerning and is arguably at odds with a purposive construction of the original Article 20 rules, namely to ensure that letter box entities weren't created.

## 2. Substance

Proposed amendments to Articles 7 and 8 of AIFMD will add further requirements to the substance rules. Principally, the new provisions require that as at

authorisation the AIFM provides details of the *'human and technical resources...'* that will be used to ensure compliance with the AIFMD requirements together with detailed information concerning roles, reporting lines, time allocation and so on.

The language used in amended Article 7 is broad in scope and there is a risk that it creates uncertainty for competent authorities insofar as the list of requirements is not expressed to be exhaustive. It is also worth noting that in connection with this requirement, the proposed text covers all persons *'...effectively conducting the business of the AIFM in particular with regard to the functions referred to in Annex I...'*. Coupled with the confirmed extension of delegation rules to cover Ancillary Functions, this raises questions over how far authorities will want to look at delegate personnel when processing AIFMD authorisation applications.

The proposed text also requires that as a minimum, the business of the AIFM will be completed *'by at least two natural persons who are either employed full-time by that AIFM or who are committed full time to conduct the business of that AIFM and who are resident in the Union...'*.

This represents an evolution of the existing requirement (which simply required that at least two people were involved) and, as a matter of practice, should not pose too many difficulties for the majority of sponsors who are generally already subject to more demanding substance requirements in the majority of European jurisdictions.

ESMA backed RTS will follow in connection with these requirements and it will be important to scrutinise these carefully when they are published.

### **3. Investor disclosure and reporting:**

Under AIFMD II, Article 23 is to be amended to include additional investor reporting covering direct and indirect fees and charges allocated to the AIF or any of its investments. In and of itself this is not an issue for closed ended funds, but the requirement to report is currently set as quarterly. Practically speaking this will require fees and costs to be clarified and signed off on a quarterly basis which seems unnecessary in a closed ended funds context. An annual reporting frequency (tied in with the annual audit) may have been a better outcome.

Annex IV reporting under Article 24 is also being extended to cover all markets,

instruments and exposures of the relevant AIFM/AIF rather than the principal/main markets, instruments and exposures as is currently the case.

RTS are expected in connection with this change to update reporting templates and deal with associated issues.

#### **4. Depositary rules:**

Changes to the depositary rules, allowing a depositary to be appointed that is located in a Member State that is not the Member State in which the AIF is established, can be inferred from the recitals of AIFMD II. Recital 29 states that *'...competent authorities should be able to permit AIFMs or AIFs to procure depositary services located in other Member States, while the Commission assesses...whether it would be appropriate to propose measures to achieve a more integrated market.'*

Unfortunately, there is no corresponding amendment proposed to the provisions of Article 21(5) which contains the current jurisdictional restriction, leaving a certain amount of uncertainty in connection with this proposed change. Article 21 is, however, to be amended to ensure that where a third country depositary is appointed (of relevance for certain third country AIFs only), the third country in which the depositary is based must meet the Third Country Qualification Requirements.

Other changes to the depositary rules recognise that where a CSD acts as custodian (rather than as an issuer CSD) it can be treated as a delegate of the depositary and the custody delegation rules will therefore apply.

The Commission will be required to review the appropriateness of introducing a depositary passporting system within five years of the date on which AIFMD II comes into force.

#### **5. Third country distribution:**

The thorny issue of AIF distribution, in particular for third country AIFs remains unresolved in the Commission proposals with no indication that the third country passport will be switched on any time soon. The Commission has, however, reduced the overall pool of third country AIFM/AIFs that can access EU investors by amending various provisions of AIFMD to require that to take advantage of the

existing third country provisions (e.g. Article 42) both the AIFM and the AIF must be based in a third country that meets the Third Country Qualification Requirements.

In practice, these additions will not be an issue for the vast majority of third country sponsors but there is uncertainty here concerning the reference to the EU list of non-cooperative tax jurisdictions.

The EU list of non-cooperative tax jurisdictions currently mentioned is the list published as at 27 February 2020, which includes the Cayman Islands. The Cayman Islands have since been removed from the list, but the AIFMD II text doesn't appear to acknowledge that this list is periodically updated. Separately, and assuming that references to the list are supposed to be 'as amended from time to time', this requirement creates further uncertainty insofar as inclusion on the list can be immediate and potentially politically driven.

## **Final thoughts...**

While the changes proposed in AIFMD II are somewhat iterative in nature, there are no clear wins for industry and it is hard to see anything in the changes that won't just add further cost and complexity to establishing and running an AIFM, for little or no commercial or regulatory benefit.

Almost all the changes represent a tightening of the existing rules and appear to pave the way for greater regulatory scrutiny and supervision. Third country managers will continue to find access to EU investors difficult (an issue that was magnified significantly with the implementation of the CBMD) and while loan origination will be open to authorised EU AIFMs, this permissions addition will be of limited appeal to most closed ended fund managers.

AIFMD II will now be presented to both the European Council and the European Parliament for their comments and a final text will be published in the EU Official Journal once this process is completed with implementation required two years after that. Expect changes in 2024/25.