Linklaters

EU plans to change AIFMD, UCITS and ELTIF regimes

November 2021

The EU Commission has released proposals to amend AIFMD, the UCITS Directive and the ELTIF Regulation.

This note summarises the proposed draft legislation and highlights the key takeaways for firms.

Links

- Draft Directive amending AIFMD and UCITS Directive
- Draft Regulation amending ELTIF Regulation

Key takeaways

> No fundamental change is proposed to the ability of AIFMs and UCITS ManCos to **delegate** their function (including to third countries) but requirements around the **minimum substance** of AIFMs and UCITS ManCos are being harmonised and tightened.

> The rules also empower ESMA to conduct a "**peer review**" every two years to assess how the EU national competent authorities oversee delegation structures by EU AIFMs / UCITS ManCos. This proposal is clearly targeted at those NCAs that have historically taken a light-touch approach to local substance and delegation requirements.

> New requirements around **liquidity management** are proposed for both UCITS and open-ended AIFs. In particular, NCAs are now empowered to require that an AIFM/UCITS ManCo activates or deactivates a liquidity management tool (LMT).

> Targeted amendments are proposed for AIFMD and UCITS to rationalise the requirements around **depositaries**.

> New and detailed **eligibility, conduct and reporting** requirements have been proposed for AIFs that undertake lending. These include a requirement to retain a 5% interest in loans that are originated and sold off.

> The asset eligibility and marketing requirements for **ELTIFs** are proposed to be significantly relaxed, particularly for ELTIFs marketed only to professional investors.

> No mention is made of the long-promised AIFMD passports for non-EU AIFMs.

> Some of these new requirements will also bite on **non-EU AIFMs** operating under the Article 42 AIFMD regime including rules regarding indirect cost disclosures and the NCA's power noted above to require an AIFM to activate or deactivate a liquidity management tool. The latter will potentially be quite burdensome for Article 42 AIFMs as this is a power that could be exercised by any of the EU NCAs in the countries where they market their fund and may well cut across the rules they are subject to in their local non-EU jurisdiction.

Commission concerns

This proposal originates from the EU Commission's review of AIFMD. The Commission felt that certain issues from that review were equally relevant to UCITS and so have sought to amend both directives. The Commission concluded, however, that AIFMD is mostly effective and meeting its objectives and so the proposed changes are relatively targeted and do not look to overhaul the current regime.

The key concerns that the Commission seeks to address are:

> The AIFMD rules on liquidity management, use of leverage and valuation are not specific enough to be suitable to the managing of direct lending activities by AIFs. There is also lack of harmonisation amongst member states which undermines an internal market for loan originating AIFs.

> The data submitted to supervisory authorities has gaps or lacks the requisite detail.

> There is no minimum harmonised set of LMTs in AIFMD or the UCITS rules.

> The current AIFMD requirement that a depositary should be located in the same member state as the appointing EU AIF is difficult to fulfil in some jurisdictions and leads to increased costs.

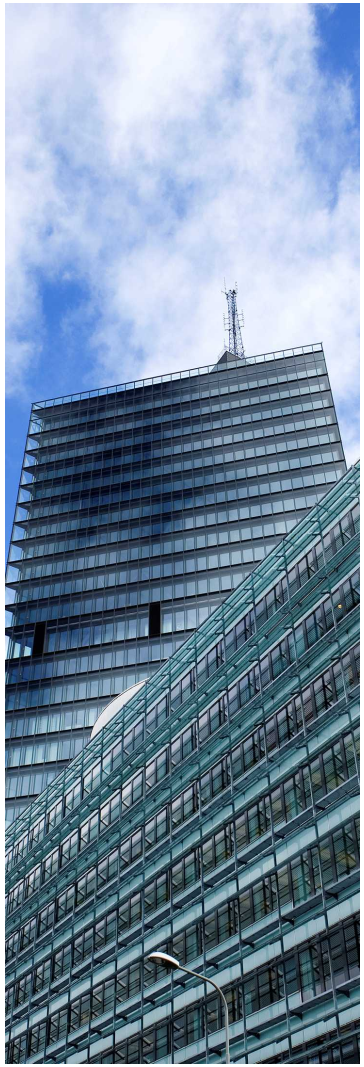
> There is evidence that, because central securities depositories (CSDs) are not considered delegates of depositaries, there is no guarantee of a stable flow of information between them.

> Whilst the delegation regime is effective in principle, the Commission's view is that different national practices create inconsistencies and reduce investor protection. Therefore it thinks more detail should be included in the EU rules on ensuring the AIFMs/UCITS ManCos deploy the necessary human resources to perform retained tasks.

With those concerns in mind, the Commission has proposed various changes to legislation which are summarised in the following slides.

Next steps

The proposals are subject to the ordinary legislative procedure, so the next step is for the European Parliament and the Council to negotiate a final legislative text on the basis of the proposals. The average length of the legislative procedure is around 18 months.



Amendments to AIFMD and UCITS Directive

Delegation

> Specifying that AIFMs/UCITS ManCos must employ or engage at least two persons resident in the EU on a full-time basis as minimum substance.

> Clarifying that AIFMs/UCITS ManCos must have appropriate technical and human resources when applying for authorisation, and that the use of these for supervising delegates must be described in detail.

> Specifying that delegation arrangements apply to ancillary services that an AIFM can perform (as well as core functions).

> Requiring NCAs to notify ESMA annually of all delegations where AIFMs/UCITS ManCos delegate more portfolio management/risk management functions to entities in third countries than they retain. Regulatory technical standards (RTS) will be developed to specify the details of these notifications.

> Requiring ESMA to regularly review the supervisory practices of NCAs through a “peer review” in applying rules on delegation with a particular focus on preventing the creation of letter-box entities.

Depositaries

> Clarifying that where the fund’s assets are kept by a CSD, the CSD is considered to be delegated custody by the fund’s depositary. This change has been proposed to enable depositaries to better fulfil their oversight duties, as the idea is that this will result in better information flows between depositaries and the CSD. However, depositaries would not have to perform due diligence where custody is delegated to CSDs.

Liquidity management

> Requiring open-ended AIFs and UCITS ManCos to choose at least one LMT (as described in new Annexes to AIFMD and the UCITS Directive). RTS will specify the details of the LMTs and the selection and use of suitable LMTs.

> AIFMs/UCITS ManCos are also required to notify NCAs about activating or deactivating LMTs.

> NCAs are also empowered to require that an AIFM/UCITS ManCo activates or deactivates an LMT. This obligation notably also applies to Article 42 AIFMs.

Amendments to AIFMD

Extension of ancillary services

> Extending the list of ancillary services AIFMs can provide to include administration of benchmarks and credit servicing. Unhelpfully, the rules still do not permit AIFMs to perform the MiFID II regulated activity of "execution of client orders" which has been a key gap in the rules and often limits firms from setting up a single EU entity with both fund management and MiFID management businesses, unless they are willing to operate a very limited EU trading desk.

Specific requirements for loan originating / lending funds

> Requiring AIFMs managing AIFs which grant loans to implement effective policies, procedures and processes for the granting of loans, including assessing credit risk and monitoring credit portfolios.

> Preventing AIFMs from lending more than 20% of an AIF's capital to a single borrower where the borrower is a financial undertaking or fund (although there is flexibility where a fund is raising or reducing capital or selling assets).

> Forbidding AIFs from lending to its AIFM or its staff, its depositary or its delegate.

> Requiring AIFs to retain a 5% skin-in-the-game of any loans they have originated and sold off, similar to the risk retention requirements that exist under the Securitisation Regulation.

> Requiring AIFs that lend more than 60% of their NAV as loans to adopt a closed ended structure to avoid maturity mismatches.

Delegation

> Explicitly forbidding sub-delegation by delegates which are unauthorised entities.

Depositaries

> Explicitly requiring depositaries to not just cooperate with their own NCA but also the NCA of the AIF and AIFM.

> Requiring NCAs to allow the appointment of depositaries in other member states (until a review is concluded on the need to establish a depositary passport).

Disclosures and reporting

> Requiring AIFMs to give additional disclosures on the conditions for using LMTs.

> Requiring AIFMs to report to investors on all direct and indirect fees and charges that were directly or indirectly charged or allocated to the AIF or any of its investments. What constitutes an “indirect” fees or charges is not defined, but we expect ESMA would look to the PRIIPs indirect costs methodologies.

> Requiring AIFMs to report to investors on the portfolio composition of originated loans.

> Removing certain limitations on the data NCAs should receive from AIFMs and proposing that ESMA develops draft RTS and ITS to replace existing supervisory reporting templates.

Updating money laundering / tax references

> Amending references e.g. to high risk FATF jurisdictions to refer to jurisdictions deemed high risk under EU money laundering legislation instead.

> It is also specified that non-EU AIFs or non-EU AIFMs must satisfy the requirement that they are not located in a third country that is deemed uncooperative on tax matters.

Amendments to UCITS Directive

Delegation

> To align with AIFMD, requiring UCITS to justify their entire delegation structure based on objective reasons to their NCAs.

> Aligning with AIFMD by empowering the Commission to adopt a delegated act specifying the conditions under which a UCITS ManCo would be deemed to be a letter-box entity.

Reporting

> Again, aligning with existing AIFMD reporting requirements, UCITS ManCos will have to regularly report to their NCA on the markets and instruments in which they trades on behalf of the UCITS they manage. ESMA is mandated to prepare RTS specifying the details and the templates that should be used for reporting.

The Commission notes that only 57 ELTIFs have been launched (as of October 2021) and these have a total AuM of €2.4bn. So, in short, the ELTIF Regulation has not been extensively used.

The Commission notes that the advantages of ELTIFs are diminished by restrictive fund rules and barriers to entry for retail investors. Its proposals aim to make ELTIFs the "go to" fund structure for long term investments by making changes to the regime and, in particular, broadening the scope of eligible investments, allowing more flexible fund rules, and reducing barriers preventing retail investors from accessing ELTIFs (e.g. the €10,000 initial investment requirement and maximum 10% aggregate threshold requirement for retail investors with portfolios below €500,000). ELTIF rules will also be eased for funds distributed solely to professional investors.

The key changes proposed are:

Eligible assets / strategies

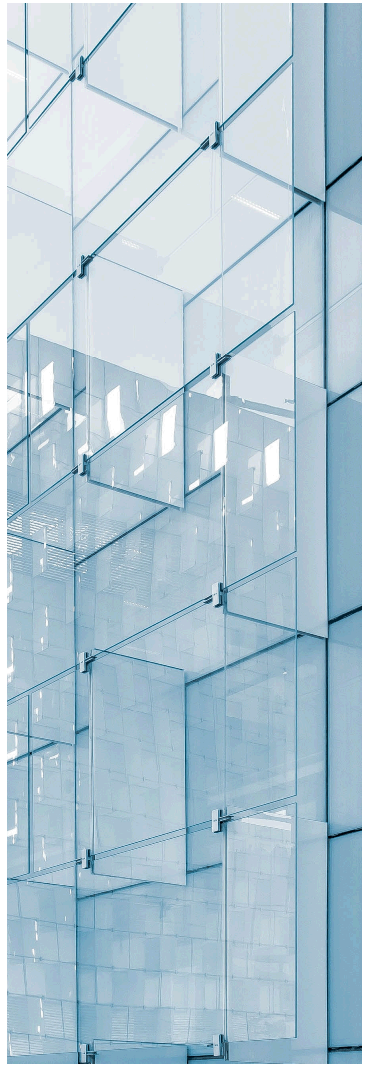
> Expanding the scope of eligible assets so they can be located in third-countries.

> Broadening the scope of "real assets" to ensure they cover all assets that have intrinsic value due to their substance and properties. This is intended to broaden the scope of real asset strategies that can be pursued, with the Commission noting that it could include e.g. 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.

> Allowing ELTIFs to make minority co-investments in investment opportunities (rather than via or in majority owned subsidiaries).

> Facilitating the ability of ELTIFs to pursue fund-of-fund investment strategies and investing beyond just ELTIFs, EuVECAs and EuSEFs in EU AIFs and UCITS as well provided those invest in eligible investments.

> ELTIFs can invest in real assets if the minimum investment value of such assets is at least €1m (down from €10m), and it is no longer required that real assets are owned directly or via "indirect holding via qualifying portfolio undertakings".



- Clarifying that eligible investments should also include STS securitisations where the underlying assets consist of long term exposures, which include four categories:
  - residential loans that are secured by mortgages on residential property;
  - commercial loans secured by mortgages on commercial property;
  - corporate loans;
  - trade receivable or other underlying or other underlying exposures that the originator considers to form a distinct asset type, provided that the proceeds are used for financing or refinancing long term investments.
- Raising the market capitalisation threshold for listed qualifying portfolio undertakings from €500m to €1bn and ensuring it is only applied at the point of initial investment.
- Lowering the 70% threshold for eligible assets to 60%.
- Increasing to 20% the maximum retail ELTIF exposures to instruments issued by or loans granted to any single qualifying portfolio undertakings, single real assets, and single eligible funds. The limit for certain other investments (e.g. certain transferable securities, fund holdings, deposits etc.) has been doubled to 10%.
- Imposing a limit of 20% exposure to STS securitisations.
- Increasing the limit on the percentage of units / shares in a single eligible fund that an ELTIF can acquire to 30%.
- Concentration limits are generally disapplied for ELTIFs marketed only to professionals.
- ELTIFs marketed to retail can increase their cash borrowings up to 50% of the ELTIF thresholds, and for those marketed to professionals up to 100%. Additional flexibility has been built in for currency related rules (e.g. allowing contracting in a currency other than the base currency where this is hedged or otherwise does not expose the ELTIF to material currency risks).
- The 30% encumbrance requirement is deleted, and it is clarified that the encumbrance of assets is permitted where it is sought to implement the borrowing strategy.
- Clarifying that borrowing arrangements fully covered by investors' capital commitments would not be considered to constitute borrowing.
- There is the possibility to set up master-feeder structures provided sufficient investor protection is ensured.

Marketing

> Similar to the changes made by the cross-border distribution of funds package for funds marketed to retail investors, deleting Article 26 which currently requires ELTIFs that are being marketed in a given member state to put in place facilities for making subscriptions, payments, repurchases / redemptions and making available information.

> Deleting Article 28 so that it removes the partial duplication of suitability assessments by ELTIF managers for retail investors. Instead, Article 30 would cross refer to MiFID II and allows ELTIF managers to market to retail investors where a suitability assessment has been carried out.

> Amending Article 30 so that the two-week withdrawal period which only applies to retail investors can only be effective during the two weeks following the effective date of the commitment/subscription agreement.

> Removing the requirement for a €10,000 minimum investment requirement and 10% aggregate threshold for the financial portfolios of retail investors with a portfolio below €500,000.

Liquidity

> ESMA is allowed to develop RTS to specify the circumstances for redemptions under limited circumstances and requiring ESMA to develop RTS specifying the information that ELTIFs need to disclose to investors.

> Enabling but not requiring ELTIF managers to include the possibility for an optional liquidity window mechanism. The matching of transfer and subscription requests can be done provided several conditions are fulfilled (e.g. having a defined policy for this mechanism).

ELTIF Register

> Requiring NCAs to report to ESMA on a monthly basis regarding authorisations granted or withdrawn or changes in information about ELTIFs.

> The ELTIF public register will also contain more granular information and provide better visibility on the ELTIF investment universe.

Authorisation

> Streamline the provisions for the authorisation of ELTIFs and clarifying that they are separate from the authorisation of the AIFM.

Organisational and disclosure requirements

> Explicitly allowing ELTIF managers and their affiliated entities and staff to invest in an ELTIF and in the same assets (e.g. to allow co-investment strategies). But additional conflicts safeguards must be applied.

> Requiring ELTIF managers to provide additional information on the ELTIF borrowing strategy and limits.

> Requiring ELTIFs to notify NCAs of the orderly disposal of assets for the redemption of investors (with the NCA being able to request an itemised schedule).

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