

November 2023

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Investment Funds & Private Capital Market Insights

AIFMD II - A Summary of the Key Changes

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10 years after the Alternative Investment Fund Managers Directive (“AIFMD”) entered into force, the Council of the European Union (“EU”) has published the final text of the political agreement reached in relation to the changes to the AIFMD. This follows an announcement on July 20, 2023 that the Council of the EU and the EU Parliament had reached agreement on the targeted amendments to the AIFMD.

The amendments to the AIFMD will introduce new rules relating to loan origination activities as well as enhanced liquidity management requirements for open-ended funds. These changes are combined with wider amendments to reporting requirements, investor disclosures and a marketing ban for non-EU AIFMs and non-EU AIFs whether either is established in a jurisdiction considered high-risk/non-cooperative jurisdictions from an AML and tax perspective, among others changes.

The team at Paul Hastings has put together a summary of the key changes to the AIFMD.

The final text of the legislation is likely to enter into force in early 2024, with an implementation date in early 2026.

Key Takeaways:

- **New regime for loan origination** – A new regulatory framework for loan origination activities undertaken by EU AIFMs in Europe will make B2B lending across the EU by EU-managed funds easier. However, this comes with concentration limits, a 5% retention requirement, restrictions on lending, and enhanced policies and procedures relating to assessing credit risk and monitoring a credit portfolio.
- **Loan origination funds** – In addition to the rules relating to loan origination activities, AIFs qualifying as ‘loan-originating AIFs’ will be subject to leverage limits and a general requirement to be closed-ended (unless the AIFM can demonstrate its liquidity risk management system is sufficient to match the AIF’s investment strategy and redemption policy).
- **Liquidity risk management tools** – New requirements on liquidity management, including a new Annex V to the AIFMD, which sets out a specific list of liquidity management tools, will

apply to AIFMs managing open-ended funds. AIFMs will need to adopt at least two liquidity management tools from the specified list in Annex V.

- **Marketing ban for high-risk non-EU countries** – Non-EU AIFMs and non-EU AIFs will be prevented from marketing in the EU if the AIFM or AIF is established in a country listed on the EU's list of high-risk third countries, or the EU's list of non-cooperative countries for AML or tax purposes respectively. This will increase the risk of using vehicles based in jurisdictions that are periodically subject to greater scrutiny on these matters, such as the Cayman Islands (which was on the tax blacklist in 2020 and is currently on the AML blacklist).
- **Increased transparency** – The scope of regulatory reporting (known as “Annex IV Reporting”) by AIFMs, including non-EU AIFMs marketing under a national private placement regime (“NPPR”), has been expanded to include more asset and market-related data as well as information in relation to the delegation arrangements for the fund. Additionally, the scope of investor pre-investment disclosures under Article 23 has been expanded.
- **Organisational requirements/substance** – The business of EU AIFMs will need to be conducted by at least two natural persons who are domiciled in the EU and who are either (i) employed full-time by the EU AIFM or (ii) who are executive members of the governing body of the EU AIFM, and who are committed to conducting the business of the EU AIFM on a full-time basis, effectively requiring more EU substance and potentially leading to higher costs for “host AIFM” models.
- **Depositories** – AIFMD II relaxes the requirement for the depository to be established in the same Member State as an EU AIF, allowing AIFMs more flexibility in terms of depository service providers. However, this is subject to the AIFM demonstrating certain conditions have been met and approval from the home EU Member State regulator of both the AIF and the AIFM.

Article:

The European Council, European Commission, and European Parliament announced on 20 July 2023 that political agreement had been reached in relation to the changes to the AIFMD, concluding discussions that began in November 2021. The final text of the political agreement has now been published. The key changes to the current AIFMD text include:

Loan Origination Activities

Under AIFMD II ‘loan origination’ or ‘originating a loan’ is defined as *“granting of a loan directly by an AIF as the original lender, or indirectly through a third party or special purpose vehicle, which originates a loan for or on behalf of the AIF, or for or on behalf of the AIFM in respect of the AIF, where the AIFM or AIF is involved in structuring the loan, or defining or pre-agreeing its characteristics, prior to gaining exposure to the loan.”*

While AIFs undertaking ‘loan origination’ activities will be subject to new requirements under the AIFMD, the primary benefit to the industry of these changes is a proposal to enable AIFs to originate loans in all Member States, overcoming the banking monopolies imposed in some EU jurisdictions for origination of even business loans. The “price” for this is a set of new risk management requirements to address (among other things) liquidity risk and interconnectedness in the financial system.

AIFs undertaking loan origination activities—regardless of whether they meet the threshold to be a “loan-originating AIF” (see below) — will be subject to the following requirements:

Concentration limit: AIFs originating loans will be subject to a concentration limit and must not make loans in excess of 20% of the AIFs capital to another AIF, UCTIS or financial undertaking (i.e. banks, insurance firm or other financial services firm)

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Restrictions on lending: AIFMs/AIFs will not be permitted to lend to the EU AIFM or its staff, the EU AIFMs delegate or its staff or the depositary of the AIF.

Member states will have the ability to restrict/prohibit AIFs originating consumer loans. Shareholder loans will be exempt from the new requirements provided that the aggregate notional value of the loans do not exceed 150% of the fund’s capital. Equally, loans purchased by a fund are outside the scope of the rules, as long as the loans were originated by a third party and the EU AIFM was not involved in structuring the loan (such as by defining or pre-agreeing its characteristics).

Risk retention: EU-managed funds undertaking loan origination activities will need to hold a 5% risk retention interest in the notional value of originated loans. While the risk retention period is nominally to hold that interest for the shorter of eight years or and the loan’s maturity, selling earlier is permitted where necessary to implement the fund’s strategy in investors’ best interests, or where the risk associated with the loan deteriorates and is disclosed to the purchaser (among other exemptions).

Enhanced policies and procedures: EU AIFMs will be required to implement up-to-date and effective policies and procedures relating to granting credit, including assessing credit risk and administering and monitoring a credit portfolio where the AIF is originating loans or purchasing loans from third parties. These policies and procedures will need to be reviewed at least annually.

Prohibition on originate-to-distribute strategies: EU AIFMs will be prohibited from managing AIFs whose investment strategy is to originate loans with the sole purpose of distributing those loans to third parties (an “originate-to-distribute” strategy).

Loan Origination AIFs

AIFMD II will also introduce a new regime for ‘loan-originating AIFs’, which will apply in addition to the above requirements applicable to loan origination activities. A loan origination AIF is a fund:

- (i) whose investment strategy is mainly to originate loans; or
- (ii) where the notional value of the AIF’s originated loans represents at least 50% of its net asset value.

In addition to the general loan origination rules, loan-originating AIFs will be subject to leverage limits of 175% for open-ended AIFs and 300% for closed-ended AIFs. Leverage for these purposes is to be calculated in accordance with the commitment method and subscription lines/facilities can be excluded from the calculation.

Loan origination AIFs are required to be closed-ended by default; however, EU AIFMs intending to raise open-ended loan origination funds will need to be able to demonstrate to their home member state regulator that the fund has liquidity management tools available that are consistent with its investment strategy, redemption policy and broader liquidity risk management framework.

As details around the rules for loan origination funds are considered it will be interesting to see how the market reacts, particularly around the structuring of new or existing open-ended funds which may fall within scope of the new requirements. While many private debt funds invest with the intention to hold loans to maturity, these new requirements may put EU loan origination activities at a disadvantage versus other global markets, particularly the US.

Liquidity Management

EU AIFMs managing open-ended funds will be required to adopt at least two (one, for money market funds) liquidity management tool such as gates, swing pricing, suspension of redemptions, etc., as specified in the new Annex V. AIFMs of these open-ended funds will also need to adopt specific policies and procedures relating to the use of liquidity management tools, and in certain circumstances AIFMs will be required to notify their home member state regulator when certain liquidity management tools are utilized.

Wider Changes

Marketing Restrictions (Article 42): Non-EU AIFMs marketing into the EU under NPPRs and non-EU AIFs will be prevented from marketing in the EU if the non-EU AIFM or non-EU AIF is established in a country listed on the EU's list of high-risk third countries, or the EU's list of non-cooperative countries for tax or AML purposes. This will increase the risk of using vehicles based in jurisdictions that are periodically subject to greater scrutiny on these matters, such as the Cayman Islands (which was on the tax blacklist in 2020 and is currently on the AML blacklist).

Pre-investment investor disclosures (Article 23): In addition to the changes specific to loan origination, further changes to the AIFMD include enhanced investor pre-investment disclosures (Art.23) relating to the name of the fund and enhanced disclosure around fees and charges, which will also be relevant for non-EU managers marketing funds in the EU. Additionally, both EU and non-EU AIFMs will be required to provide disclosures to investors regarding the funds liquidity risk management framework.

Annex IV Reporting (Article 24): Reporting changes will require EU AIFMs to provide regulators with more details on their delegation arrangements. While EU AIFMs must already notify their home member state regulator of delegation arrangements, AIFMs will now be required to report the total delegated AUM and percentage of the portfolio (as opposed to the top five positions), the organisational structure of the delegate, and details regarding the individuals and functions involved at the delegate, and conduct periodic diligence reviews to monitor the delegate. It is expected that EU AIFMs will be required to use a prescribed reporting template which should be published in due course. When coupled with increased substance requirements for EU AIFMs (needing at least two EU-resident directors working on the business full-time), this is a particularly interesting development, and could be an indication of future changes to follow, led primarily by political motivations of certain EU member states that are seeking to capture high-value portfolio management services currently undertaken in London under delegation arrangements and redomicile those activities to the EU.

Following the reporting changes relating to delegation, AIFMs will also be required to report on all direct and indirect fees and charges connected to the operation of the fund on an annual basis. Again, further details will follow in due course. Changes to the scope of regulatory Annex IV Reporting by AIFMs, including non-EU AIFMs marketing a fund under an EU national private placement regime, will include additional

asset- and market-related data. The changes to Annex IV reporting will apply a year after most other new AIFMD II requirements apply (i.e. 2027).

What's next?

With the final text of the political agreement between the Council and the EU Parliament released, we expect the final legislative text will be published in the EU's Official Journal in early 2024. Member States will have 24 months to apply AIFMD II in national rules, meaning that implementation for majority of AIFMD II provisions can be expected by early 2026.

Sponsor's currently structuring new funds should consider the impact of the new rules on upcoming fund structures, particularly those funds undertaking loan origination/direct lending activities or those established in jurisdictions currently listed on the EU tax or AML blacklist.

Go Deeper:

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