DILLON EUSTACE

DUBLIN CAYMAN ISLANDS NEW YORK TOKYO

6 March 2023

What to look out for in the trialogue negotiations on AIFMD and UCITS reform

In November 2021, the European Commission (**Commission**) published its legislative proposal to amend both the UCITS and AIFMD frameworks (**Commission Proposal**). Since then, both the European Parliament (**Parliament**) and the Council of Europe (**Council**) have published revised iterations of the Commission Proposal incorporating their suggested amendments.

Proposed reforms to the AIFMD and UCITS frameworks are wide-ranging and include new rules on delegation and liquidity management, changes to the depositary regime and supervisory reporting framework as well as a proposal to introduce a pan-EU framework for loan originating AIFs[1].

Trialogue negotiations on the legislative proposal begin later this week and the Swedish Presidency of the European Council has indicated that it aims to reach agreement by June 2023 when its term ends.

In this briefing, we consider some of the key issues to be monitored by Irish fund management companies and their funds during the upcoming trialogue negotiations between the EU institutions.

Delegation

- Given that Irish fund management companies are already subject to more onerous substance requirements than those proposed by all three of the European institutions, resourcing requirements are unlikely to be an area of concern. However, Irish third-party management

[1] For a detailed overview of the proposals put forward by the Commission in its proposal, please refer to our client briefing on this topic.

Key areas to monitor during the trialogue negotiations:

- The Council proposal to impose a leverage cap on funds which engage in loan origination, the ability for such funds to be structured as open-ended and the precise scope of the rules for any funds engaging in loan origination activities.
- Scope of delegation reporting requirements and proposal to subject third party management companies to additional conflict of interest provisions; and
- Ability of NCAs to require a management company to (de)activate a specific liquidity management tool in certain circumstances

companies[2] are likely to be interested in whether the Parliament's proposal under which they will be required to employ "heightened scrutiny" for the potential for conflicts of interest and to submit "detailed explanations and evidence" of compliance to their national competent authorities (**NCA**) will be supported by the Commission and the Council and included in the finalised agreed legislative text. Criticised by industry bodies as being an unnecessary overlay of existing conflicts of interest provisions, neither the Commission nor the Council have suggested similar proposals.

- The scope of the periodic reporting obligations to NCAs on delegation arrangements is also likely to be an area of some concern for fund management companies. For example, one of the more contentious proposals put forward by the Council is that each fund management company will be required to provide information to its NCA on any issues identified by it as part of its periodic due diligence on its delegate as well as the timeframe and measures adopted to address any such identified issue. Given the broad scope of this proposal and the fact that the proposed text provides ESMA with regulation-making powers to set out the detail of such reporting obligations, fund management companies will be interested to see whether the Council's proposal is retained in the finalised text.

- ESMA's role in supervising delegation arrangements more generally is another area which is likely to be monitored closely by the Irish fund management community given that the information gleaned from such supervision is likely to inform future supervisory action and may result in a more substantial overhaul of the third country delegation rules by the Commission in the future which could impact the current Irish delegation model.

- Under proposals put forward by both the Council and the Parliament in an effort to avoid double regulation, the marketing of shares of a fund by an EU distributor which is already subject to rules imposed under MiFID II or the Insurance Distribution Directive will not constitute a "delegation arrangement" for which the fund management company is responsible.

Liquidity Management Tools

- Of significant concern for fund management companies is the Commission's proposals to empower NCAs to force fund management companies with open-ended funds to (de)activate certain liquidity management tools (**LMT**), including the temporary suspension of trading or application of redemption gates (whether or not such tools are provided for under the fund documentation) in certain circumstances. The proposals, if adopted, would constitute a significant fettering of the discretion of such fund management companies in managing the liquidity risk within a given portfolio. While the Parliament has proposed imposing some additional parameters around the use of such powers by NCAs, the asset management industry has been strongly advocating for the adoption of the Council's proposal to resist the granting of such powers to the NCAs.

[2] Those management companies appointed to manage an AIF or UCITS where a third party (such as a delegate investment manager or promoter) has significant control over the design, distribution and management of the relevant fund

- Adopting a similar stance, the Council is also resisting the Commission's proposal to provide ESMA with the power to force (i) a non-EU AIFM marketing AIFs which it manages within the EEA or (ii) EU AIFMs managing non-EU AIFs to (de)activate LMTs where investor protection or financial stability risks necessitate the exercise of such powers.

Loan Origination Fund Regime

Under the Commission Proposal, EU AIFMs managing loan-originating funds will be required to comply with certain requirements in order to address the "the potential micro risks and macro prudential risks that loan originating AIFs could pose and spread to the broader financial system" including, amongst others, rules on risk retention and risk diversification. While Irish loan-originating funds are already subject to a domestic framework which imposes requirements to ensure such risks are managed appropriately, the new proposals will mark a significant shift for unregulated AIFs established in other EU jurisdictions such as Luxembourg which implement such strategies without being subject to any specific rules around loan origination.

The following issues relating to loan origination are likely to be heavily debated during the upcoming trialogue negotiations:

- ***Imposition of a leverage cap for loan-originating AIFs***

  The Council has proposed imposing a leverage cap under which AIFs engaged in loan origination (including via an SPV) will be required to limit their leverage to 150% of the net asset value of the AIF with this limit not applying to shareholder loans or temporary borrowings which are fully covered by contractual capital commitments from investors. There is likely to be some considerable resistance to imposing leverage limits (and particularly at such a level) for this product type where it is not imposed for other investment strategies, particularly given that (i) the existing AIFMD regulatory framework already imposes rules around leverage which must be complied with by all AIFMs and (ii) the Council proposal does not currently provide for an exemption for leverage generated through hedging.

- ***Possibility of a loan-originating AIF being established as an open-ended fund***

  Irish loan-originating AIFs must be established as closed-ended structures. However, the Commission has proposed that a fund engaged in loan origination could be established as an open-ended fund where the notional value of its originated loans is less than 60% of NAV provided that an appropriate liquidity management system is in place. The Council and the Parliament both remove this 60% threshold and instead propose that an open-ended structure can be used provided that the liquidity management system ensures that the redemption policy is aligned with the liquidity of the underlying investments. Both institutions propose that ESMA be required to develop implementing rules setting down specific requirements which will need to be satisfied for such funds to maintain an open-ended structure. Unlike the Commission, both institutions also propose certain grandfathering provisions for existing AIFs. This will be keenly watched by those fund management companies who want to house a loan-origination strategy within a fund which offers investors some limited redemption rights.

- ***Scope of Loan Origination Rules***

  Neither the Commission nor the Council has proposed calibrating the loan origination rules so that they would only apply to AIFs which engage in loan origination as a core element of their investment strategy. However, the Parliament has proposed including a definition of "loan-originating AIF" being an AIF "whose principal activity is to originate loans and for which the notional value of its originated loans exceeds 60% of its net asset value". We therefore expect the concept of "loan-originating AIFs" and the precise scope of the rules for any AIF which engages in loan origination to be the subject of discussion during the upcoming trialogue discussions.

Scope of services provided by AIFM

- One area of reform likely to be welcomed by Irish AIFM which manage loan-originating strategies is the proposal to recognise lending as a legitimate activity of AIFMs which would allow AIFMs with such permissions to act on behalf of an AIF domiciled in one Member State to lend to entities domiciled in another Member State. The servicing of securitisation special purpose entities will, if implemented as currently proposed, also be included in the scope of the management of AIFs.

- The list of non-core services which can be provided by AIFMs is also likely to be extended to include providing benchmark administration services under the Benchmarks Regulation and the provision of credit servicing under the EU Credit Services Directive.

Treatment of "Grey List" Entities

One final area which is likely to be heavily debated during the trialogue negotiations relates to the treatment of countries appearing on the "Grey List" under the AIFMD framework. The Parliament has suggested that where a country has appeared on the "Grey List" for a period of three years, such country should automatically be considered to be a "Black List" country which would have significant implications for non-EU funds, non-EU depositaries and non-EU AIFMs located in such jurisdictions wanting to access the EU market.

Conclusion

There are a number of key issues relevant to Irish fund management companies which will need to be resolved during the upcoming trialogue negotiations. We will keep you updated as these negotiations progress but, in the meantime, if you have any questions arising from this briefing, please get in touch with your usual contact in the Dillon Eustace Asset Management and Investment Funds team.

Dillon Eustace LLP
6 March 2023

Etain de Valera
DD: + 353 1 673 1739
Etain.deValera@dilloneustace.ie

Cillian Bredin
DD: + 353 1 673 1889
Cillian.Bredin@dilloneustace.ie

Derbhil O'Riordan
DD: + 353 1 673 1755
Derbhil.ORiordan@dilloneustace.ie

David Walsh
DD: + 1 646 770 6080
David.Walsh@dilloneustace.ie

Shane Coveney
DD: + 353 1 673 1749
Shane.Coveney@dilloneustace.ie

Joe O'Doherty
DD: + 353 1 673 1734
Joe.ODoherty@dilloneustace.ie

DILLON EUSTACE

Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022

New York
33 Irving Place, New York, NY10003, U.S.A. Tel: +1 646 770 6080

Tokyo
12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885