

# Clients & Friends Memo

## Liquidity Management, Loan Origination and Credit Funds under AIFMD II

14 March 2024

### I. Background and Scope

On 7 February 2024, the European Union adopted a final text amending the AIFMD and UCITS directives (**AIFMD II**). This memo considers what are entirely novel requirements attaching to liquidity management and loan origination activities by alternative investment funds (AIFs) managed by EEA AIFMs and their implications for credit funds once AIFMD II is fully in force (i.e. 20 days after publication in the EU Official Journal).

The new rules apply only to AIFs managed by an EEA AIFM (and not AIFs marketed under NPPR by non-EEA AIFMs) but apply to any AIF an EEA AIFM manages and assets of such AIF regardless of domicile.

Note that:

- The new provisions, and their grandfathering, apply differently to any AIFs managed by EEA AIFMs that originate loans and “loan-originating AIFs”; and
- The liquidity management rules apply to all open-ended AIFs managed by EEA AIFMs regardless of strategy.

### II. What is ‘Loan Origination’ and a ‘Loan-originating AIF’?

The revised directive now will include the following new definitions:

“**loan origination**” or “**originating a loan**” means the 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 an 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.

“**loan-originating AIF**” means an AIF:

- whose investment strategy is mainly to originate loans; or
- whose originated loans have a notional value that represents at least 50% of its net asset value.

“**leveraged AIF**” means an AIF whose exposures are increased by the AIFM that manages it, whether through borrowing of cash or securities, leverage embedded in derivative positions or any other means.

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“**shareholder loan**” means a loan which is granted by an AIF to an undertaking in which it holds directly or indirectly at least 5% of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in the same undertaking.

### III. Prohibition on Syndication Strategies

New Article 15(4)(h) required Member States to prohibit AIFMs from managing AIFs that engage in loan origination when the whole or part of the investment strategy of those AIFs is to originate loans with the sole purpose of transferring those loans or exposures to third parties.

#### **Grandfathering provisions**

These provisions do not apply in respect of loans originated before the date that AIFMD II comes into force. AIFMs may continue to manage such AIFs without complying in respect of those loans.

### IV. Borrower Limitations

New Article 15(4)(a) requires an AIFM to ensure that, where an AIF it manages originates loans, the notional value of the loans originated to any single borrower by that AIF does not exceed in aggregate 20% of the capital of the AIF where the borrower is a financial undertaking, an AIF or a UCITS<sup>1</sup>.

This limit is subject to a 24-month ramp-up period (with a national competent authority discretion to increase to 36 months depending on asset class) and ceases to apply following the end of the investment period or, for open-ended funds, is subject to temporary suspension when capital is increased or reduced through subscriptions or redemptions.

#### **Grandfathering / transitional provisions**

These provisions do not apply to AIFs that do not raise additional capital after the date that AIFMD II comes into force. AIFMs of such AIFs shall be deemed compliant.

Otherwise, these provisions applies to EU AIFMs (managing AIFs that originate loans and are in existence prior to the date AIFMD II comes into force) five years from the date the directive is in force/implemented.

### V. Leverage Limits

#### **What are the new limits?**

New Article 15(4)(b) requires an AIFM to ensure that the leverage of a loan-originating AIF it manages represents no more than:

- 175%, where that AIF is open-ended; or
- 300%, where that AIF is closed-ended.<sup>2</sup>

#### **How is leverage calculated for this purpose?**

The leverage of a loan-originating AIF shall be expressed as the ratio between the exposure of that AIF, calculated according to the “commitment method” and its net asset value.

Borrowing arrangements which are fully covered by contractual capital commitments from investors in the loan-originating AIF shall not be considered to constitute exposure for the purpose of calculating this ratio.

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<sup>1</sup> Subject to the application of specific conditions under the ELTIF, EUSEV and EUVECA Regulations.

<sup>2</sup> These limits are subject to member state gold-plating.

Calculation of leverage using the commitment methodology is set out in the Delegated Regulation 231/2013 for AIFMD I. Borrowing arrangements “fully covered” by contractual capital commitments can be excluded from the calculation.

**Rectification**

In the event that a loan-originating AIF infringes the limits and the infringement is beyond the control of the AIFM that manages it, the AIFM shall, within an appropriate period, take such measures as are necessary to rectify the position, taking due account of the interests of the investors in the loan-originating AIF.

**Shareholder loan exemption**

These limits shall not apply to a loan-originating AIF whose lending activities consist solely of originating shareholder loans, provided that the notional value of those loans does not exceed in aggregate 150% of the AIF's capital.

**Grandfathering / transitional provisions**

These provisions do not apply to AIFs that do not raise additional capital after the date that AIFMD II comes into force. AIFMs of such AIFs shall be deemed compliant.

Otherwise, these provisions apply to EU AIFMs which are managing AIFS that originate loans and are in existence prior to the date AIFMD II comes into force) five years from the date the directive is in force.

However, as from the date AIFMD II is in force, during that five-year period an AIFM must not increase leverage of an AIF which either has already originated loans above the financial borrower limitation limit or has leverage above the limits set out above. If below those limits, the AIF may raise its leverage to those limits but no further.

**VI. Open-ended vs Closed-ended**

New Article 16(2)(a) now requires an AIFM to ensure that a loan-originating AIF is closed-ended. However, a loan-originating AIF may be open-ended provided that the AIFM that manages it is able to demonstrate to its national regulator that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy.

**Grandfathering / transitional provisions**

This provision does not apply to AIFs that do not raise additional capital after the date that AIFMD II comes into force. AIFMs of such AIFs shall be deemed compliant.

This provision applies to EU AIFMs which are managing AIFS that originate loans and are in existing prior to the date AIFMD II comes into force) five years from the date the directive is in force.

**VII. Liquidity Management for Open-ended Funds**

New Article 16(2)(b) requires an AIFM that manages an open-ended AIF to select at least two appropriate liquidity management tools from the list now set out in new Annex V (this list is set out in the appendix to this note), and the two must be in addition to any powers for suspensions and side pockets and selecting only one of either swing or dual pricing. The AIFM must assess the suitability of those tools in relation to the pursued investment strategy, the liquidity profile and the redemption policy of the AIF, and the use of these tools must be empowered by the AIF's constitution.

The AIFM must have and implement detailed policies and procedures for the activation and deactivation of any selected liquidity management tool and the operational and administrative arrangements for the use of such tool.

Redemptions in kind may be activated to meet redemptions requested only by professional investors and if the redemption in kind corresponds to a pro rata share of the assets held by the AIF, provided that the redemption in kind need not correspond to a pro rata share of the assets held by the AIF if that AIF is solely marketed to professional investors, or if the aim of that AIF's investment policy is to replicate the composition of a certain stock or debt securities index and that AIF is an exchange-traded fund.

Other powers included in Article 16(2) are a temporary suspension power and use of side pockets, both of which may be used only in exceptional cases and where circumstances so require and where justified having regard to the interests of the AIF investors. Use of either of these powers requires the AIFM to notify its national regulator without delay (for suspensions) or within a reasonable timeframe (for side pockets).

ESMA will develop regulatory technical standards (RTS) in relation to these requirements, including what represents a sound liquidity management system, the availability of liquid assets and stress testing, as well as an appropriate redemption policy having regard to the liquidity profile of loan-originating AIFs. Those requirements also shall take due account of the underlying loan exposures, the average repayment time of the loans and the overall granularity and composition of the portfolios of loan-originating AIFs. In addition the RTS shall specify the characteristics of the liquidity management tools set out in Annex V.

In addition, ESMA must develop guidelines on the selection and calibration of liquidity management tools by AIFMs for liquidity risk management and for mitigating financial stability risks, including indications as to the circumstances in which side pockets can be activated.

### **VIII. Risk Retention Requirement**

New Article 15(4)(i) requires an AIFM to ensure that the AIF it manages retains 5% of the notional value of each loan that the AIF has originated and subsequently transferred to third parties. That percentage of each loan shall be retained:

- until maturity, for loans whose maturity is a period of up to eight years (or for loans granted to consumers regardless of their maturity); and
- for a period of at least eight years for other loans.

#### **Exemptions**

This requirement does not apply following the end of the AIF's investment period or where assets are sold to meet redemptions or a liquidation. In addition, it is disapplied where the sale of the loan is necessary to enable the AIFM to implement the AIF's investment strategy in the best interests of its investors or the sale of the loan is due to a deterioration in the risk associated with the loan, detected by the AIFM as part of its due diligence and risk management process, and the purchaser is informed of that deterioration when buying the loan.

#### **Grandfathering provisions**

These provisions do not apply in respect of loans originated before the date that AIFMD II comes into force. AIFMs may continue to manage such AIFs without complying in respect of those loans.

### **IX. Policies and Procedures**

A new Article 15(3)(d) requires an AIFM which engages in loan-origination activities to have effective policies, procedures and processes for granting loans. In addition, an AIFM which is managing loan originating AIFs, including when those AIFs gain exposure to loans through third parties, should have effective policies, procedures and processes for granting loans, assessing credit risk and for administering and monitoring their credit portfolio. These policies and procedures must be kept up to date and reviewed at least once a year.

**Shareholder loan exemption**

There is an exemption for shareholder loans when the notional value of such loans does not exceed in aggregate 150% of the AIF's capital.

**Grandfathering provisions**

These provisions do not apply in respect of loans originated before the date that AIFMD II comes into force. AIFMs may continue to manage such AIFs without complying in respect of those loans.

**X. Attribution of Loan Proceeds**

New Article 15(4)(f) requires that when an AIF originates loans, the proceeds of the loans, minus any allowable fees for their administration, shall be attributed to that AIF in full.

All costs and expenses linked to the administration of the loans must be disclosed in pre-investment disclosures and regular reporting for the purposes of Article 23.

**Grandfathering provisions**

These provisions do not apply in respect of loans originated before the date that AIFMD II comes into force. AIFMs may continue to manage such AIFs without complying in respect of those loans.

**XI. Related Party Loans**

New Article 4(e) requires an AIFM to ensure that no AIF it manages grants a loan to staff, any depositary, delegate or group company and their respective staff.

In order to avoid conflicts of interest, AIFMs and their staff are to be prohibited from receiving loans from any AIFs they manage, as are staff of delegates, depositories and entities in the same group as the AIFM. The group company prohibition does not apply to an entity that is a financial undertaking that exclusively finances borrowers who are not in any of these prohibited categories.

**Grandfathering provisions**

These provisions do not apply in respect of loans originated before the date that AIFMD II comes into force. AIFMs may continue to manage such AIFs without complying in respect of those loans.

**XII. Loans to Consumers**

New Article 15(4)(g) sets out a member state discretion to prohibit an AIF granting loans to consumers in its territory.

**Grandfathering provisions**

These provisions do not apply in respect of loans originated before the date that AIFMD II comes into force. AIFMs may continue to manage such AIFs without complying in respect of those loans.

**XIII. Next Steps****Timing**

AIFMD II is expected to be published in the Official Journal of the European Union shortly and will come into force 20 days after that date. Member States then have two years to implement the provisions into domestic legislation.

Much of the important detail is yet to be seen and we are expecting the related regulations and draft RTS to be published during Q2 and Q3 2024. Those are likely to be finalised for the first anniversary of AIFMD II and we may well see early adopters bringing in their domestic implementation legislation to coincide or shortly after.

#### **Appendix - Liquidity Management Tools Available to AIFMs Managing Open-ended AIFs**

1. **Suspension of subscriptions, repurchases and redemptions:** suspension of subscriptions, repurchases and redemptions means temporarily disallowing the subscription, repurchase and redemption of the fund's units or shares.
2. **Redemption gate:** a redemption gate means a temporary and partial restriction of the right of unit-holders or shareholders to redeem their units or shares, so that investors can redeem only a certain portion of their units or shares.
3. **Extension of notice periods:** the extension of notice periods means extending the period of notice that unit-holders or shareholders must give to fund managers, beyond a minimum period which is appropriate to the fund, when redeeming their units or shares.
4. **Redemption fee:** redemption fee means a fee, within a predetermined range that takes account of the cost of liquidity, that is paid to the fund by unit-holders or shareholders when redeeming units or shares, and that ensures that unit-holders or shareholders who remain in the fund are not unfairly disadvantaged.
5. **Swing pricing:** swing pricing means a pre-determined mechanism by which the net asset value of the units or shares of an investment fund is adjusted by the application of a factor ("swing factor") that reflects the cost of liquidity.
6. **Dual pricing:** dual pricing means a pre-determined mechanism by which the subscription, repurchase and redemption prices of the units or shares of an investment fund are set by adjusting the net asset value per unit or share by a factor that reflects the cost of liquidity.
7. **Anti-dilution levy:** anti-dilution levy means a fee that is paid to the fund by a unit-holder or shareholder at the time of a subscription, repurchase or redemption of units or shares, that compensates the fund for the cost of liquidity incurred because of the size of that transaction, and that ensures that other unit-holders or shareholders are not unfairly disadvantaged.
8. **Redemption in kind:** redemption in kind means transferring assets held by the fund, instead of cash, to meet redemption requests of unit-holders or shareholders.
9. **Side pockets:** side pockets means separating certain assets, whose economic or legal features have changed significantly or become uncertain due to exceptional circumstances, from the other assets of the fund.

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