

Understanding AIFMD: liquidity management tools

Insights - 13/06/2024

In this series of briefings from our Investment Funds team in Luxembourg, we are summarising changes to the Alternative Investment Fund Managers Directive (AIFMD)^[1], which entered into force on 15 April 2024^[2].

Member States have 24 months to transpose these changes to AIFMD (the AIFMD II)^[3] into their national laws.

In this briefing, we are focusing on the shift the AIFMD II brings in the regulation of open-ended funds, emphasizing robust liquidity management under stressed market conditions.

There have always been concerns about liquidity risk in open-ended alternative investment funds (AIFs). An open-ended AIF is an AIF that does not have a set number of shares or units. Depending upon investors' demand, the AIF will issue or redeem shares / units on a continuous or periodic basis. This open-ended nature can create liquidity risk when a position in a fund's portfolio cannot be liquidated at limited cost and in an adequately short timeframe in order to fulfil a redemption request. Those liquidity issues may even be exacerbated by the political and market events. Recognising the growing necessity of safeguarding the liquidity of AIFs in times of increased redemption stress, the EU Commission has put on the liquidity management tools (LMTs) at the disposal of alternative investment fund managers (AIFMs).

Definitions of liquidity management tools

The new Annex V to the AIFMD II lists and defines LMTs that will be available to AIFs going forward:

- (1) **suspension of subscriptions, repurchases and redemptions** - temporarily disallowing unitholders or shareholders from subscribing, purchasing or redeeming the fund's units or shares
- (2) **redemption gate** - temporary and partial restriction of the right of unitholders or shareholders to redeem their units or shares, so that investors can only redeem a certain portion of their units or shares

- (3) **extension of notice periods** - extending the period of notice that unitholders 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** - a fee within a predetermined range that takes account of the cost of liquidity, that is paid to the fund by unitholders or shareholders when redeeming units or shares, and that ensures that unitholders or shareholders who remain in the fund are not unfairly disadvantaged
- (5) **swing pricing** - 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**: - a pre-determined mechanism by which the subscription 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** - a fee paid to the fund by a unitholder or shareholder when purchasing or redeeming 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 unitholders or shareholders are not unfairly disadvantaged
- (8) **redemptions in kind** - transferring assets held by the fund, instead of cash, to meet redemption requests of unitholders or shareholders
- (9) **side pockets** - separating certain assets, whose economic or legal features have changed significantly or became uncertain due to exceptional circumstances, from the other assets of the fund

More detailed characteristics of the LMTs will be specified by way of regulatory technical standards (RTS), taking into account the diversity of investment strategies and underlying assets, all while ensuring AIFMs may use any LMT appropriate for their asset classes and market conditions.

It is to note that the Annex V to the AIFMD II represents minimum requirements and expressly provides for the possibility for Member States (MS) to introduce additional LMTs in their national laws.

Compulsory selection of LMTs for open-ended funds

Two main LMTs, which are to be always available, albeit as a final solution, are the suspension of subscriptions, repurchases and redemptions and side pockets. A pivotal shift under AIFMD II is the new requirement for AIFMs managing open-ended AIFs to select at least two appropriate LMTs from the items 2 to 8 listed above, and include these in the AIF's rules or instruments of incorporation

for possible use in the interest of the AIFs investors. Suitability of selected LMTs shall be assessed by the AIFM in relation to the investment strategy, the liquidity profile and the redemption policy of the AIF. It shall not be possible for that selection to include only swing pricing and dual pricing.

If the AIF is authorised as a money market fund in accordance with Regulation (EU) 2017/1131, the AIFM is allowed to select only one of the tools listed in points 2 to 8.

Selection and calibration of LMTs, as well as specific details on side pocket activation, will also be further clarified by way of RTS.

(De)activation of LMTs

The AIFM has to implement detailed policies and procedures for the activation and deactivation of any selected LMT and the operational and administrative arrangements for its use. Both the LMT selection and policies and procedures have to be communicated to the AIFM's home MS national competent authority (the **NCA**).

Redemption in kind can only be activated to meet redemptions requested by professional investors and correspond to a 'pro rata' share of the assets held by the AIF, unless that AIF is marketed solely to professional investors, or the AIF is an exchange-traded fund (**ETF**) replicating the composition of a certain stock or debt securities index.

Notification on LMT (de)activation to NCA

An AIFM shall, without delay, notify the NCA of its home Member State as follows:

- where an AIFM activates or deactivates the suspension of subscriptions, repurchases and redemptions (Annex V, point 1)
- where the AIFM activates or deactivates any of the liquidity management tools referred to in points 2 to 8 of Annex V, in a manner that is not in the ordinary course of business as envisaged in the AIF rules or instruments of incorporation

An AIFM shall, within a reasonable timeframe before it activates or deactivates side-pockets (Annex V, point 9), notify the NCA of its home MS of such activation or deactivation^[4].

In the particular context of the suspension of the issue, repurchase or redemption of shares / units that may be requested by the NCA of the home MS of the AIFM, and only in the interest of the AIFs investors, the NCA of that MS shall notify, without delay, the NCA of a host Member State of the AIFM (such as the MS in which the AIFM manages and / or markets the AIF), the European Securities and Markets Authority (**ESMA**)^[5] and, if there are potential risks to the stability and integrity of the financial system, the European Systemic Risk Board (**ESRB**)^[6] of any notifications received. ESMA shall have the power to share the received information with NCAs.

Powers of NCAs / ESMA on LMT (de)activation

In exceptional circumstances and in order to safeguard the interests of investors, NCAs shall have the power (after consulting the AIFM in question) to require AIFMs to activate or deactivate the suspension of subscriptions, repurchases and redemptions (AIFMD II, Annex V, item 1) where there are risks to investor protection or financial stability that, on a reasonable and balanced view, necessitate such activation or deactivation.

In relation to a non-EU nexus, it is ESMA that shall have the power to require (after consultation with the AIFM) in exceptional circumstances and in order to safeguard the interests of investors, (i) the non-EU AIFMs that are marketing EU AIFs that they manage, or (ii) EU AIFM managing non-EU AIFs to activate or deactivate the suspension of subscriptions, repurchases and redemption, where there are risks to investor protection or financial stability that, on a reasonable and balanced view, necessitate such activation or deactivation.

Temporary suspension of subscriptions and redemptions

AIFMs that manage open-ended AIFs may, in the interest of AIF investors, temporarily suspend subscription, repurchase or redemption of the AIF units or shares or, where those tools are included in the AIF's rules or instruments of incorporation, activate or deactivate other liquidity management tools selected. AIFMs may also, in the interest of AIF investors, activate side pockets as referred to in item 9 of the list above.

In any event, all AIFs may activate suspensions or side pockets, and this in exceptional cases where circumstances require so and where this is justified having regard to the interests of the AIF investors.

Liquidity management for loan origination investment strategies

As mentioned in our [briefing on loan origination](#) under the AIFMD II, loan origination is a strategy usually better fit for closed-ended funds. However, the AIFMD II does not exclude open-ended AIFs from originating loans and clarifies LMT-related conditions for open-ended AIFs having loan origination as part of their strategy.

For an open-ended AIF to be allowed to originate loans, its AIFM will have to demonstrate to the NCA that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. This requirement will apply as of 16 April 2029; pre-existing AIFs not raising additional capital after 15 April 2024 will be deemed compliant.

Further requirements loan originating AIFs need to comply with in order to maintain the open-

ended status will be developed in future RTS. The RTS will cover 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 shall also 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.

Precontractual and periodic disclosures

In their offering document and annual reports, AIFs will have to describe their liquidity risk management, including redemption rights in normal and exceptional circumstances, existing redemption arrangements with investors, and of the possibility and conditions for using LMTs.

Conclusion

In a nutshell, AIFMD II has put a strong emphasis on the use of LMTs in the context of a growing concern about liquidity issues as a result of economic and political circumstances.

Our reading of the new rules leads to a conclusion that the EU tried to strike a balance and reconcile best interests of remaining and redeeming investors by nuancing rules on the use of compulsory and elective LMTs and leaving it to ESMA to render more technical details which will take into account differences in underlying investment strategies.

Besides that, AIFMs managing open-ended AIFs are now required to manage the liquidity risk more effectively by selecting at least two appropriate LMTs in relation to the pursued strategy.

Supervisory powers of NCAs and ESMA have been enhanced, on one hand by requiring AIFMs to notify their NCA of the activation and deactivation of LMTs and, on the other, by the possibility for NCAs and ESMA to activate subscription and redemption suspensions for individual AIFs.

Finally, even though the AIFMD II will have a 24-month transposition deadline and a deferred application period of five years for certain provisions, we can consider liquidity management to be one of the key items on the agenda of both regulators and sponsors in the near future.

[1] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

[2] The AIFMD II intends to amend the UCITS directive as well, however in this series, we will be covering only the proposed amendments to the AIFMD.

[3] Directive (EU) 2024/927 of the European Parliament and of the Council of 13 March 2024

amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds

[4] The home MS NCA will be further notifying the host NCA, ESMA, and, if there are risks to the financial system integrity, the ESRB.

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