AIFMD REGULATION

Keeping on top of the paperwork

The Alternative Investment Fund Managers Directive is adding to fund managers' regulatory burdens. Patricia Volhard, partner at P+P Pöllath + Partners, examines some of the disclosure obligations

Volhard: *compliance with AIFMD requirements could be a more pressing issue for smaller and also non-EU managers*

The list of regulatory items to be taken into consideration by private equity fund managers is long and growing. This is largely driven by the implementation of the Alternative Investment Fund Managers Directive (AIFMD), under which every European private equity fund manager is subject to supervision and registration requirements in their home member state. Many of those prudent requirements are related to disclosure and transparency, with additional disclosure the result of institutional investors in private equity funds being subject to their own regulatory requirements. Such disclosure applies in addition to AIFMD requirements for annual reports which are not covered here.

As a result of the AIFMD, managers of private equity funds need to be either authorised or registered as a sub-threshold manager in their home member state. In the latter case they are usually exempt from most of the AIFMD requirements and the directive has had little impact on them so far.

However, cross-border marketing within the EU for such sub-threshold managers has become extremely difficult and even impossible in countries where only fully authorised AIFMs are permitted to market within the EU. Therefore, at least when preparing for the next fund, sub-threshold managers may be required to re-consider an opt-in and to obtain full scope authorisation in order to be able to market. Hence, compliance with AIFMD requirements could also become a more pressing issue for such smaller managers.

Non-EU managers that have filed for marketing within the EU also have to comply with the AIFMD reporting and anti-asset-stripping standards. Once the marketing passport for non-EU managers is introduced, non-EU managers to which the passport regime is available will no longer be able to rely on the private placement filings in countries like Germany where such managers can then only market by making use of the passport and being fully AIFMD compliant.

DISCLOSURE OF FEES AND EXPENSES

An important aspect addressed in the AIFMD disclosure is transparency of the entire cost structure of the fund. Fees and expenses borne by the fund need to be properly disclosed.

Even if the disclosure of fees has already been market standard in the private equity funds sector, even more care should be given in future to such disclosure to ensure that all foreseeable potential expenses are included in the list of costs to be borne by the fund.

Generally, disclosure may further increase due to other upcoming changes, such as the PRIIPs-Regulation (packaged retail investment and insurance product) which comes into effect on 31 December 2016. Under this, additional key information leaflets will be required in case a fund is also marketed or later advertised or sold on the secondary market to non-professional investors (which may include high net worth individuals).

These short, highly standardised leaflets are meant to inform about the fund's risk and return profile, including potential losses, the term and premature disinvestment possibilities, the costs involved and the type of investor the fund is intended for.

MOST-FAVOURED NATIONS TREATMENT

The AIFMD requires a fair treatment of investors but does not require equal treatment as long as any preferences are

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established in the fund rules or articles of association and do not cause an overall material disadvantage to certain other investors. The common practice to issue side letters granting preferential treatment only to certain investors for tax and regulatory or other objective reasons complies with the AIFMD provided that such preferential treatment, the type of investors obtaining it, the reasoning behind it, as well as the legal or economic links with the fund and its manager are disclosed to all investors prior to them making an investment. Such disclosure is a challenge in case of several closings.

It remains to be seen whether regulators will also accept carve-outs from most-favoured nations treatment where it remains fully at the manager's discretion whether such treatment will be granted or not.

CONFLICTS OF INTERESTS

Under AIFMD the manager is required to have a solid conflicts of interest policy in place and to disclose potential conflicts. For example, this means that if funds managed by the same manager have overlapping strategies, allocation rules need to be put in place to ensure that the allocation decisions are not driven by a potential conflict of interest. Often investors ask for specific language to be included in the fund rules to address such concern. There are several ways to deal with it; the more flexibility the fund rules leave for the manager to determine how to allocate investment opportunities in case of overlapping strategies, the higher the standard to be fulfilled by the internal policy.

DISCLOSURE OF STAKES IN UNLISTED PORTFOLIO COMPANIES

The target portfolio company receiving private equity funding is generally not subject to special regulation unless national law provides otherwise. However, due to the AIFMD, managers of private equity funds acquiring a stake in a portfolio company with seat in the EU and not qualifying as small and medium-sized company (the "Target Company") are subject to certain reporting requirements. The manager must notify its competent regulator about the voting rights held by the fund it manages in an unlisted Target Company, as soon as the proportion of voting rights of the unlisted Target Company reaches, exceeds or falls below the thresholds of 10, 20, 30, 50 and 75 percent.

In case it obtains the majority of voting rights (alone or together with other funds managed by it or another manager on the basis of an agreement) such reporting includes: informing the Target Company and other shareholders among others about the manager's identity; its arrangements to manage conflicts of interests; its intentions for the company's future development and the effects on employment; the date and conditions of the acquisition; the identity of the different shareholders involved; and the chain of undertakings through which voting rights are held.

The manager must use best efforts to ensure that the Target Company's management forwards the information to its employees or their representatives. The home regulatory authority of the manager must also be notified (if the manager is a non-EU manager that has filed for marketing in the EU, each regulatory authority where it has filed must be informed).

The stakeholder disclosure rules and their scope are not always clear. For example, with respect to the acquisition of a group of portfolio companies, the reasonable interpretation of the disclosure rules seems to be to look through the acquisition companies set up for purposes of making the acquisition but to stop at the level of the top holding company of the group acquired by the fund. Applying these provisions to each group entity would make transactions of this type unmanageable.

SOLVENCY II

Insurance investors which are subject to Solvency II require certain information in order to meet their capital adequacy requirements which are calibrated according to the individual risk profile of the investor, including its asset portfolio.

To paint the most realistic picture of the investor's economic situation the investor has to look through to the assets held by the fund. The capital requirements for investments in private equity depend, among others, on the value of the investor's pro rata share in the portfolio companies held by the fund. To calculate the required capital the investor will request the so-called Solvency II reporting which includes certain information on the portfolio companies.

The fulfillment of such Solvency II reporting by the manager can be a challenge where the manager itself is subject to confidentiality obligations. This should be borne in mind when negotiating confidentiality agreements. ■