

Legal and Practical Issues under the AIFMD

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he European investment funds landscape has dramatically changed since the EU-wide implementation of the Alternative Investment Fund Managers Directive (AIFMD). Even though the AIFMD has now been in force for about three years, there are still numerous legal and practical issues that are unsolved.

AIFMD Reporting

The AIFMD requires each Alternative Investment Fund Manager (AIFM) to regularly report to the competent authorities of its home Member State a comprehensive set of information on the AIFM and on its investment funds (AIF). The information an AIFM must report depends on whether the AIFM is fully regulated (full set of information necessary) or whether the AIFM is a so-called sub-threshold AIFM (starkly reduced set of information). A sub-threshold AIFM is in general an AIFM that manages a maximum of EUR 500 million of assets or, where leveraged, a maximum of EUR 100 million of assets.

The information required in the reports is specified by an over 20 pages long annex template of the Level II Regulation to the AIFMD. The required information encompasses in the region of 300 data fields, including the following: general information on the AIF (name etc.),

investment strategy, key risks and concentrations, main instruments and exposures, risk profile (market, counterparty, liquidity, and stress testing). With regard to private equity structures, the reporting template includes about 20 data fields with information on the typical deal size, typical position size, and any dominant influence the AIF might have.

The contents and the format of the AIFMD reporting are heavily standardized by templates and instructions prepared by the European Securities and Markets Authority (ESMA). In order to be able to assess and process the information, ESMA and accordingly the German regulator BaFin require a submission of the data in machine readable XML format.

The frequency of the reporting varies from quarterly to annually, depending on, among other things, the assets under management and the use of leverage. The reports must be submitted within one

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month after the applicable reporting period (i.e. the end of January for annual reports). This can cause difficulties as the information required for the reports is at such point only available on a preliminary basis.



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Managers then have to use the preliminary information and have to make a subsequent amendment filing if the information changes (e.g. due to different numbers after the audit of the financial statements).

Annual Reports

The AIFMD has another “hot topic” contained in the requirements to submit annual reports for the AIFs. These requirements apply to fully regulated AIFMs and to third-country managers with regard to their AIFs marketed in the European Union, but not to sub-threshold AIFMs.

The basic information required in the annual report is not much different from the applicable accounting standards. The accounting information in the annual reports must be prepared in accordance with the accounting standards applicable to the AIF. Accordingly, the

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annual report consists of a balance sheet, a profit-and-loss statement, and an activities report.

The “hot topic” is rather that the annual report must contain the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries, and, where relevant, carried interest paid by the AIF. In addition, the annual report must contain the aggregate amount of remuneration broken down by senior management and members of

staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Although overall, the requirement to include remuneration disclosures (including disclosure of overall carry amounts extracted by carry limited partners) is not strictly speaking new, the difficulty for AIFMs going forward will be how to deal with placing staff in significant management functions within the AIFM when they are themselves entitled to carry as this can trigger quite a specific disclosure depending on the individual or individuals involved. Strategies are evolving to deal with this situation but in practice there is no clear guidance available as to what is in fact appropriate.

Valuation

The AIFMD introduces rules and procedures for valuing the assets of an AIF. Such rules make sense from the investors’ perspective as well as from the overall perspective of the AIFMD, in encouraging the monitoring of systemic risks in the financial markets. Unsurprisingly, the assets must be valued “fairly and appropriately”. For that purpose, the AIFMD requires that the AIFM sets up rules and procedures. The AIFM must also have a valuation function, i.e. either an independent external valuer with sufficient qualifications or the AIFM itself if the internal function is sufficiently separated.

The AIFMD valuation rules do not apply to sub-threshold AIFMs. However, sub-threshold AIFMs have their own valuation issue. An AIFM may only stay sub-threshold as long as its assets under management do not exceed EUR 500 million or, in case of leveraged AIFs, EUR 100 million. Depending on whether the AIFM can value at cost or at fair value, such threshold is reached more slowly (or indeed not at all) or significantly

faster. According to the German regulator BaFin, German GAAP (HGB) shall apply in order to determine the threshold. This rather uniform standard is likely intended by BaFin to minimize subjective views on the valuations. Other jurisdictions have adopted different approaches leading to jurisdictional arbitrage in the application of this provision which is of course contrary to the purpose of AIFMD. The valuation with regard to the EUR 500 million or EUR 100 million threshold is fortunately less of an issue for commitment based funds. ESMA recently clarified that undrawn capital commitments are not assets under management and therefore do not count against the thresholds.

Depositary Requirement

The AIFMD introduced from the UCITS Directive the requirement to appoint a depositary for in-scope AIFMs/AIFs. The depositary requirement is, at least partly, a response to the Madoff scandal. Accordingly, the basic functions of a depositary are cash-flow monitoring, safe-keeping of assets (including ownership verification), and general oversight (e.g. with regard to subscription or distributions).

The depositary requirements apply to fully regulated AIFMs, but not to sub-threshold AIFMs. The requirement has also become relevant to third-country managers who want to market their AIFs in the European Union. Some EU Member States (such as Germany and

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Denmark) require the appointment of a depositary with the aforementioned functions in order to market an AIF to professional investors.

Although the majority of the depositary requirements in an alternative assets context are straightforward in their application, the big issue remains the treatment of “financial instruments” (MiFID definition); the associated liability regime, how they must be held and what they are. Little guidance has been produced on this issue and the strict liability regime layers unnecessary additional cost into the holding of these assets. The imposition of a depositary for professional investor backed AIFs is arguably misconceived and it would be helpful if some of these issues were addressed in the eagerly awaited AIFMD II.

Marketing under the AIFMD

The AIFMD significantly changed the marketing regime for AIFs marketed to institutional investors. Even though there have been marketing rules for retail funds pre-AIFMD, the AIFMD introduced specific rules for marketing AIFs to institutional and professional investors. There are, at the moment, basically three marketing regimes available: an EU marketing passport for fully regulated EU AIFMs, the national private placement rules with regard to EU sub-threshold AIFMs, and the AIFMD marketing regime for third-country managers.

The hardest hit by the new marketing regime has been in our experience on EU sub-threshold managers and third-country managers wanting to market their AIFs in the European Union. EU sub-threshold managers must check the marketing requirements in each EU country before marketing a fund there. Whereas some EU countries allow such cross-border marketing (such as the UK, Luxembourg, and in general also Germany), others do not allow the cross-border marketing of EU sub-threshold managed AIFs (such as Austria or Denmark). Third-coun-

try managers must apply in each EU country for a so-called Art. 42 AIFMD marketing license. Such license is often a lengthy and costly process. Turn-around time at BaFin is in practice between one and two months with regulatory fees of EUR 6,582 one-time and EUR 1,088 annually.

As a consequence of the stricter marketing, the concepts of pre-marketing and reverse solicitation have become more prominent. However, none of the concepts are very clear and managers relying on them often do so in a gray area due to the lack of practical guidance from the regulators.

Summary

Overall, although AIFMD is a relatively straightforward piece of legislation, building on the pre-existing UCITS requirements for retail funds, it is generally accepted as being poorly drafted and there is significant uncertainty about the construction of a number of its terms which has led to significant jurisdiction arbitrage in its application.

The majority of the practical issues (which principally centered around the reporting regime) are now being resolved as AIFMs complete their first and subsequent reporting processes, but questions still arise concerning remuneration disclosures, marketing approaches and the scope of the marketing provisions, the application of the depositary regime (in particular to financial instruments) and other more technical issues (such as the application of the leverage provisions).

The introduction of AIFMD heralded the start of pan-European regulation for alternative asset invested funds and since its transposition a wide range of further EU-based regulation (Solvency II, IORPD, EMIR, and so on) framed by reference to the definitions of AIFM and AIF has been passed. It is not yet certain whether AIFMD II will help or hinder the application of AIFMD, but it is clear that further change and therefore uncertainty lies ahead for the alternative assets fund industry.

