

AIFMD

Answers to Questions Most Frequently Asked by U.S. and Other Non-E.U. Managers on the Impact and Implementation of the AIFMD

By Samuel K. Won and Simon Whiteside

The Alternative Investment Fund Managers Directive (AIFMD) continues to dominate discussions on global hedge fund regulation, marketing, remuneration, risk, reporting and related topics. In this guest article, two of the leading global authorities on the AIFMD – Samuel K. Won, Founder and Managing Director of Global Risk Management Advisors, and Simon Whiteside, a Partner in the London office of Simmons & Simmons LLP – provide comprehensive answers to 14 of the questions most frequently asked by U.S. and other non-E.U. managers on the impact and implementation of the AIFMD. Specifically, Won and Whiteside discuss the viability of reverse enquiry; the interaction between capital introduction and reverse enquiry; reliance on national private placement regimes; remuneration, side letter and leverage disclosure; AIFMD versus Form PF; content and frequency of AIFMD reporting; Annex IV reporting on master funds; and AIFMD-relevant risk management and reporting considerations.

Marketing/Reverse Enquiry

HFLR: What are others doing?

Whiteside and Won: While in July 2013, many U.S. managers were attracted to the idea of using “reverse enquiry,” where an investor invests in an AIF at its own initiative, as time has gone by more and more such managers are appreciating the restrictive nature of this exemption as well as the compliance burden associated with ensuring that investments from E.U. investors do not fall outside the exemption and thereby run the risk of the investor being able to exercise an “investor put” as a result of illegal selling of shares/interests in the relevant AIF. This, coupled with the relative accessibility of certain E.U. national private placement regimes established under AIFMD Article 42 (including a widespread relaxation on the requirement for U.S. and other

non-E.U. managers to make “Annex IV” reports in respect of non-E.U. master AIFs which only have non-E.U. feeder AIFs/aren’t marketed in the E.U. – see below), has led to an increasing number of U.S. managers registering funds for marketing in a number of E.U. jurisdictions, notably the United Kingdom, Finland and The Netherlands.

HFLR: What should I do if I want to rely on reverse enquiry?

Whiteside: As noted above, the reverse enquiry exemption requires an E.U. investor to invest in the AIF at its own initiative. This means that the manager and its marketing teams must only act in a reactive rather than proactive manner, providing such investors with only the information regarding products which have been requested. The initiative must remain with the investor throughout the lifetime of the promotion process – there is no cut-off whereby promotion carried out before AIFMD came into force may be ignored. In order to seek to restart the process, many managers ceased to provide investors with information at the time AIFMD came into force, and sent short communications to their contacts that they were doing so. Managers also analysed marketing lists and promotional materials, and in certain cases sought confirmations from contacts, as to whether they are in the E.U. or not. In addition, in order to reduce the number of persons receiving information about an AIF to those who were either (1) already invested in the relevant AIF or (2) had made specific requests to receive the relevant materials, many managers “scrubbed” their marketing lists. Care was also taken to ensure that promotional materials and other information relating to an AIF did not include any information about any other AIF, which would otherwise run the risk of “contaminating” a reverse enquiry analysis.

HFLR: How does cap intro work with marketing/reverse enquiry?

Whiteside: Cap intro is one of the more complicated aspects of the new regime. Because “marketing” under AIFMD is the offering or placement of shares or units “by or on behalf of” the manager, one of the questions relating to cap intro is whether the organiser is acting on the manager’s behalf. This is a grey area as there are arguments that organisers who are affiliated with service providers of an AIF, such as prime brokers, may benefit from the raising of capital by receiving increased brokerage or other dealing commissions. Care should therefore be taken that any materials which are being provided to prospective investors do not constitute marketing under AIFMD, as defined in the relevant member state.

In addition, in relation to reverse enquiry, any manager relying on this exemption must take care that any event attended does not “contaminate” the argument that the investment is made at the investor’s initiative. Accordingly, managers have been performing due diligence on events to ensure that no mention is made of specific products, but rather that only a manager’s “strategy” is described. In addition, sales forces are being trained to only answer questions posed, and not to volunteer additional information or documentation not requested by a prospect. The organisers of cap intro events have also been taking steps to ensure that prospective investors are made aware of the new regime, for example by providing a regulatory overview as part of the introduction to the event, so that investors are aware that managers will not be able to market in the same manner as previously and, if they want to be able to invest, then will have to take the initiative in the process.

HFLR: If I elect to use national private placement regimes, how long does it take and for how long will I be able to rely on them?

Whiteside: The procedures for applying to market under the Article 42 national private placement regimes differ from one member state to another.

In the United Kingdom, for example, which is one of the “easiest” jurisdictions, a manager has only to send a short notification to the FCA and await a confirmation of receipt in order to be permitted to market to professional investors in the U.K. The form requires the manager to self-certify compliance with the various requirements of AIFMD which are triggered by marketing (disclosure to investors, regular “Annex IV” reporting to the FCA and the production of the annual report – as well as, in the case of certain strategies, requirements when controlling or material positions are taken in European companies and issuers). The timeframe is therefore the period required to produce AIFMD-compliant documentation to provide to investors. In other jurisdictions, the process takes longer and is dependent upon the relevant competent authority registering or approving the AIF for marketing. There will therefore be a “blackout” between the time of application and the relevant registration being made or approval being granted. For example, the regulator in Sweden has sixty days to register the AIF (though is in fact taking longer). There is also the question of additional documentation and service providers being required in order to meet the requirements of certain regulators. In Germany, for example, as well as a number of specific documents having to be submitted to the regulator, an AIF is also required to have appointed providers of the so-called “depository-lite” services (which are also required under the Article 36 national private placement regimes available to E.U. managers marketing non-E.U. AIFs in Europe).

The continuing availability of the national private placement regimes is dependent upon two events:

Firstly, under AIFMD Article 67, ESMA, the pan-European securities regulator, has until July 22, 2015 to provide the European Commission, Council and Parliament with advice as to whether the pan-European marketing passport, currently only available to E.U. AIFs managed by E.U. AIFMs, should be extended to non-E.U. AIFs and non-E.U. AIFMs. ESMA published a Call for Evidence on November 7, 2014, the deadline for which is January 8, 2015. On the assumption that a positive view is forthcoming, then the Council has three months (i.e., by October 22, 2015) to propose legislation that would

extend the passport to non-E.U. AIFs and non-E.U. managers. It could reasonably be expected that such legislation would not come into force until sometime in 2016.

Secondly, under AIFMD Article 68, ESMA has until three years from the date of that legislation coming into force to provide further advice, this time as to whether the national private placement regimes should be “switched off” and, as a result, the only means of raising capital in the E.U. will be by way of being AIFMD-compliant or relying on reverse enquiry. As for the first stage, if ESMA’s advice is positive, then the Commission has three months to propose draft legislation to effect this change. Again, there would be a certain period of time between the legislation being proposed and it coming into force.

On the basis of timing of the introduction of legislation, it would be reasonable to assume that national private placement regimes will remain available until 2019 at the earliest (though the deadline could, in theory, be as soon as July 22, 2018). It should also be remembered that competent authorities may decide at any time to remove a currently available national private placement regime independent of the process described above. It should also be borne in mind that under AIFMD Article 69, the Commission is charged with producing a general review of AIFMD by July 2017, including the national private placement regimes.

Transparency

HFLR: What is the remuneration disclosure? Who gets to see it?

Whiteside and Won: Non-E.U. AIFMs marketing AIFs in the E.U. are required to make two types of remuneration disclosures in the relevant AIF’s annual report: quantitative disclosures, as described in AIFMD Article 22(e) and (f), and qualitative disclosure, as described in Chapter XIII of ESMA’s “Guidelines on Sound remuneration under AIFMD.” In relation to the quantitative disclosures, there are three options which are set out in Level 2 Regulation Article 107(1) – we

believe that for managers who have multiple funds, the option to disclose the total proportion of the remuneration of the staff of the AIFM attributable to the AIF, indicating the number of beneficiaries, will be the most popular option.

The annual report, including the remuneration disclosure, has to be made available within six months of the end of the financial year to which it relates, and must be made available to investors (not just E.U. investors) on request – see AIFMD Article 24(1). The annual report should also be made available to the national competent authorities of the member state(s) where the AIF is being marketed.

Won: We believe that many investors may still hold non-E.U. AIFMs to the same or similar standard as E.U. AIFMs. That is, that they may want these funds to be able to demonstrate that the fund has remuneration policies as well as processes in place in order to promote sound and effective risk management and not encourage risk taking that is inconsistent with the risk profiles and risk parameters of the AIFs it manages.

HFLR: Do I have to disclose the terms of my side letters?

Whiteside: AIFMD Article 23(1)(J) requires an AIFM to provide a prospective investor in an AIF with, amongst other things, a description of any preferential treatment granted to investors, or the right thereto, before that prospective investor invests in the AIF. By analogy to the reporting requirement in relation to preferential treatment required as part of the “Annex IV” report under AIFMD Article 24(2), it is not thought that Article 23(1)(X) requires granular disclosure of each side letter term, but rather a higher-level description of the types of terms which have been granted.

HFLR: Do I have to disclose leverage calculated according to AIFMD?

Whiteside: Yes. Under AIFMD Article 23(5), a non-E.U. AIFM that markets an AIF in the E.U. has to report the total amount of leverage employed by that AIF on a

regular basis. Further guidance can be found in the Level 2 Regulation at Article 109 which, at paragraph (5), states that the “total amount of leverage calculated in accordance with gross and commitment methods employed by the AIF shall be disclosed as part of the AIF’s periodic disclosure to investors . . .” We interpret this as requiring both calculations to be disclosed. It should be noted, however, that there is nothing in AIFMD to prevent an AIFM from employing a third method if it thinks that such method more accurately describes the risk associated with the leverage employed, and disclosing this at the same time as the figures calculated in accordance with the gross and commitment methods.

Won: There is no equivalent leverage calculation in Form PF for hedge funds, with the exception of certain information related to borrowings that private equity fund managers must report. Therefore, many non-E.U. hedge fund managers will likely not be familiar with nor have much experience calculating their leverage under the methods as prescribed under AIFMD unless they have had prior experience with UCITS reporting. It is important for managers to note that although AIFMD does not distinguish between “hedge funds,” “private equity funds” or “liquidity funds,” content and frequency of Annex IV reporting will depend on manager AUM, AIF AUM, whether the AIF is open- or closed-ended and whether leverage is used “on a substantial basis.”

Annex IV Reporting

HFLR: How different is this from Form PF?

Won: Although there are broad similarities between AIFMD and Form PF reporting, U.S. and other non-E.U. AIFMs should be aware of a number of important substantive as well as nuanced differences. First, for the purposes of Form PF, reporting is based upon the non-E.U. AIFM’s fiscal year while under Annex IV, reporting is based upon the calendar year of the relevant AIF. Second, a U.S. or other non-E.U. AIF that markets an AIF to investors in Europe under available national private placement regimes established under AIFMD Article 42 must file an Annex IV report in each of

the jurisdictions where that AIF is marketed, as well as comply with any other additional local requirements. Under Form PF, managers are required to file only with one regulator, the SEC. Furthermore, and as mentioned above, under AIFMD, depending upon the type of AIF being marketed and the amount of assets under management, AIFMs are required to report on a quarterly, semi-annually or annual basis (and in some rare cases, a mixture of the two), whereas Form PF reporting is either quarterly or annually and the reporting deadlines are solely determined by a firm’s size and strategy. Lastly, under Form PF, fund managers have a relatively longer reporting deadline after the fiscal period (60-120 days). Under AIFMD, the deadline is much shorter, being one month after the end of the reporting period (with the exception of reporting in respect of an AIF which is a fund of funds where the manager has an additional 15 days to file the report).

Both AIFMD and Form PF forms have sections within them for assumptions. However, only Annex IV allows assumptions at the firm as well as fund level. For AIFMD purposes, reporting at the fund level is distinct from reporting at the firm level. A separate set of assumptions, for example, may be needed in instances when a fund files independently of the firm.

There are a number of questions for AIFMD reporting that either exist only in AIFMD or are quite different than Form PF reporting. For example, under AIFMD, managers must state the name of each portfolio company in which the relevant AIF has a “dominant influence.” Form PF does not have an equivalent question. Another example of a question that exists in AIFMD that does not exist within Form PF reporting is that an AIFM must report its expected annual investment return in “normal market conditions.” In other instances, even questions that appear to be very similar, in AIFMD to Form PF, require a different approach. For example, under AIFMD, for “value of borrowings,” an AIFM is required to report the value of borrowings embedded in financial instruments through the use of derivatives. By contrast, under Form PF, there is no such requirement to calculate and disclose such information as part of “value of borrowings.”

We believe managers would be wise to ensure that they properly account for all differences between AIFMD and Form PF reporting so that they do not inadvertently report incorrect information to their regulators and thereby raise red flags.

HFLR: To whom does the AIFM report?

Whiteside and Won: A non-E.U. AIFM should report to the national competent authority of each E.U. member state where it is marketing AIFs in accordance with AIFMD. Accordingly, where an AIF is marketed in multiple E.U. member states, different Annex IV reports may have to be prepared to meet each such member state's specific requirements.

HFLR: What determines frequency/deadlines?

Whiteside: The frequency of Annex IV reporting is determined by the assets under management of the E.U. AIFs managed by the AIFM and the AIFs that it markets in the E.U. (see Level 2 Regulation, Article 110(3)). For non-E.U. AIFMs, subject to the proviso in the next sentence in relation to the U.K., the reporting period is either quarterly or half-yearly. The U.K. has also implemented a "small non-E.U. AIFM" regime, which covers AIFMs whose assets under management (of all AIFs, not just those marketed in the E.U.), when calculated in accordance with the AIFMD commitment method, fall below certain thresholds. This regime requires less frequent and less onerous reporting. Other member states have not implemented such a parallel regime. There are also annual regimes for private equity funds (e.g., closed ended, non-leveraged) AIFs.

The Annex IV reporting in respect of AIFs, which are not funds-of-funds, must be made within one month of the end of the relevant reporting period. Funds-of-funds have an additional 15 days in which to file the report. Note that in respect of reports for Q4 2014, the deadline for reporting on AIFs, which are not funds of funds, will fall on Saturday, January 31, 2015. In the U.K. at least, the FCA has stated that while filings may be made on that date, they do not guarantee that any technical support

will be available as it is a weekend. Managers should therefore aim to file before close of business on the last business day before the deadline, i.e., Friday, January 30, 2015.

HFLR: Do I have to do Annex IV reporting on my master fund?

Whiteside: For non-E.U. AIFMs, in the U.K. in respect of a non-E.U. master AIF which has only non-E.U. feeders which are marketed in the E.U., or other non-E.U. investors and therefore is not marketed in the E.U., the answer is "no" (see Paragraph 29 of the FCA's communication to non-E.U. AIFMs published on September 29, 2014, as restated in answer 22(c) of the FCA's "Questions and Answers" on "Reporting transparency information to the FCA" (which was last amended on November 28, 2014)).

Since the FCA took its stance, according to local counsel, other Member States (but not all) have followed suit. As at the time of writing, non-E.U. AIFMs are not required to provide Annex IV in respect of non-E.U. AIFs that aren't marketed in the EEA, Finland, Germany, The Netherlands, Luxembourg and Belgium. In Sweden, the regulator has confirmed that no such reporting will be required in respect of Q4 2014, and while such reports would currently be required in respect of future reporting periods, this is under review. In Ireland, while the Central Bank has previously stated that it would require such reports, we understand that this is also currently under review. See also "*U.K. FCA Guidance Confirms Simplified Transparency Reporting for Certain Private Placements of Master-Feeder Funds*," The Hedge Fund Law Report, Vol. 7, No. 44 (Nov. 20, 2014).

HFLR: What risk measures do I have to report?

Won: An AIFM is required to report risk measures such as Net Equity Delta, Net DV01 by three specified maturity buckets (5 yrs, 5-15 yrs, and >15 yrs). In contrast, Form PF requires similar risk statistical measures to be reported by only hedge funds. It is important for fund managers to be aware that under AIFMD, alternative investment funds (i.e., hedge funds, liquidity funds,

private equity funds) are not treated differently in terms of which sections of the form must be answered. For funds that fall within full scope of the directive (Level 2 Regulation), the risk management requirements go well beyond just the risk-related reporting requirements in Annex IV. For example, AIFMs must establish and maintain a risk-management policy that fully takes into consideration the risk profile of the AIFs. Specifically, this policy must include elements for how investment risks are being measured and monitored; how risks are being managed through risk limits; how risk management responsibilities (governance) work and are allocated; and how conflicts of interest are treated along with controls in place to ensure that the risk function is independent. In addition, an AIFM must be able to demonstrate that appropriate and effective liquidity management policies and procedures are in place. Another area of concern that fund managers should be cognizant of is that AIFMD sets out both initial capital that an AIFM must hold when it becomes an AIFM along with additional capital requirements that are also pegged to AUM. It is likely that even funds that are only required to do the Annex IV reporting will still be subject to testing by the regulators who will want to evaluate whether the risk reporting is accurate but also that the fund is staying within the risk profile parameters represented to investors.

HFLR: What about VaR?

Won: For value-at-risk (VaR), EEA regulators may also require an AIFM to report the results of an AIF's VaR if it is calculated for the fund for any purpose. For example, this is the case in the U.K. However, it is important to note that not all member states will be requiring non-E.U. AIFMs to report VaR data. Under Form PF, a fund manager must report whether it uses any risk metrics (outside of VaR) that it considers important to the fund's risk management, but does not require reporting of the results of these risk measures. We have found that VaR and reporting of this risk statistic can be very controversial, especially when it comes to risk-related regulatory and investor reporting. Many funds are either not equipped because of lack of risk management staff and/or systems to produce this calculation, while other funds are either trying to avoid

reporting this risk statistic because they do not want to provide this kind of risk transparency to their investors and regulators.

HFLR: How will the risk management requirements that AIFMs must comply with also affect or "filter down" to those funds that do either reverse solicitation or employ a private placement mechanism?

Won: Given the ever increasing regulatory and secular trends towards more risk-based regulations and transparency, regardless of whether a fund falls under the AIFMD directive, funds will be forced to not only provide greater and better risk transparency but also must prove that they in fact monitor and manage risk in a prudent manner that is consistent with how they represent their risk profile to both their regulators and investors.

Samuel K. Won is the Founder and Managing Director of Global Risk Management Advisors, Inc., the leading independent risk management advisory and implementation firm that provides institutional-quality risk management services to asset managers and institutional investors. He has over 25 years of experience in risk analysis and reporting, risk infrastructure implementation, risk strategy, capital markets, trading and portfolio management at major global financial institutions and asset management firms. He has advised major hedge funds, private equity funds, other asset managers, institutional investors and regulatory agencies, such as the SEC, CFTC, the Federal Reserve Bank, the OCC, FHLB and the FCA, on major risk management, trading and capital markets issues and policies.

Simon Whiteside is a Partner at Simmons & Simmons LLP. Simon specialises in advising hedge fund managers on all aspects of AIFMD, as well as on fund formation and structuring of funds and other collective investment products.

Glossary

AIF	An “alternative investment fund” for the purposes of AIFMD – in broad terms, a collective investment undertaking which is not an E.U.-regulated UCITS.
AIFM	The manager of an AIF.
AIFMD	E.U. Directive 2011/61/EU on Alternative Investment Fund Managers.
E.U	The 28 member states of the European Union plus Liechtenstein, Norway and Iceland.
Level 2 Regulation	The European Commission’s Delegated Regulation (EU) No. 231/2013.
Non-E.U. AIF	An AIF that (1) is not authorized or registered in a member state; or (2) does not have its registered office in the E.U.
Non-E.U. AIFM	An AIFM that does not have its registered office in the E.U.