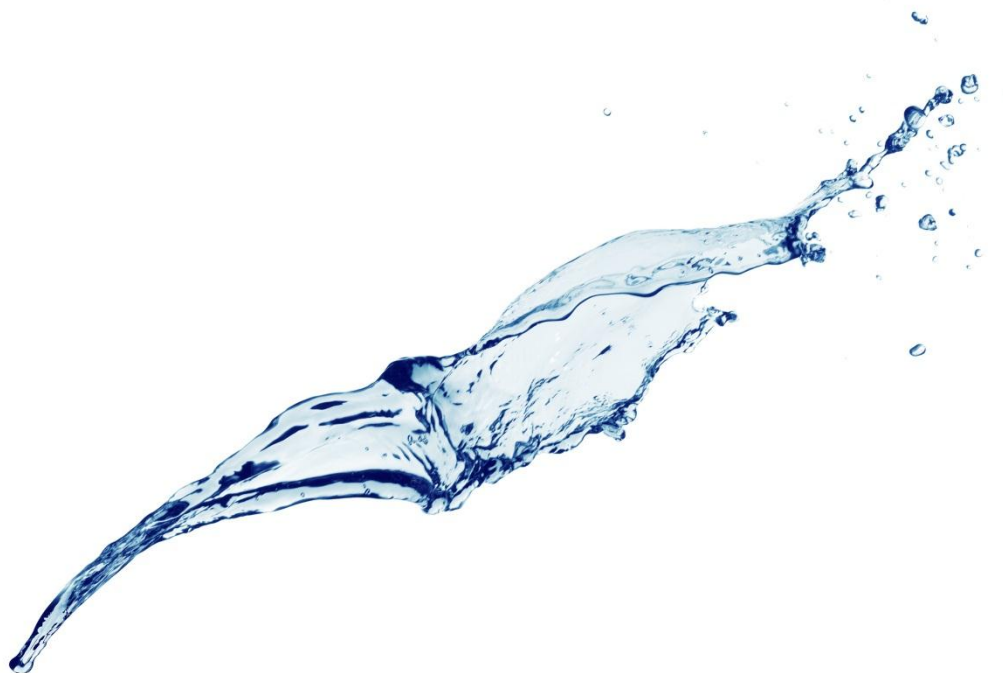


AIFMD
transparency rules
Impact on
the annual report
of AIFs



The Alternative Investment Fund Managers Directive (AIFMD) includes “transparency requirements” which are applicable to AIFMs marketing and or/managing AIFs in the EU. The transparency requirements relate to the annual report, investor disclosures and regulatory reporting. This briefing outlines the impact of the transparency requirements on the annual report of the AIF in terms of how, when and in what format information might be disclosed.

Overview

The AIFMD, which was transposed into national law in Luxembourg on 12 July 2013, sets out minimum line items and disclosures that must be presented within an Alternative Investment Fund's (AIF) annual report. An AIF is broadly defined as a collective investment vehicle other than a UCITS and includes all undertakings for collective investment established under part II of the amended Law of 2010 on undertakings for collective investment (Part II UCIs), qualifying specialised investment funds (SIF-AIFs) and qualifying risk capital investment companies (SICAR-AIFs) within a Luxembourgish context and potentially other unregulated vehicles. Managers of vehicles potentially falling within scope should conduct a detailed analysis against the criteria outlined in ESMA's "Guidelines on key concepts of the AIFMD" and seek advice to confirm their status.

The AIF annual report broadly reflects existing practices, recognising and relying on existing laws and regulations applicable to the preparation of annual accounts as well as the accounting rules laid down in the fund's instruments of incorporation. However, the Directive does include a number of noteworthy changes and additions, particularly in relation to remuneration, leverage and liquidity.

Alternative Investment Fund Managers (AIFMs) also need to consider potential interaction with the investor disclosure requirements, which relate to pre-investment, regular and periodic disclosures. Material changes to pre-investment disclosures must be detailed in the annual report while in other cases it may be appropriate to include certain investor disclosures within the annual report as part of the periodic reporting. This briefing provides suggestions in that regard.

Scope and timing

The deadline for the publication of the annual report of an AIF is within 6 months of year-end. In Luxembourg this will only be a change for Part II UCIs where previously the requirement was within 4 months.

Listed closed ended funds will continue to have a 4 month deadline for filing their annual report. In Luxembourg, Part II UCIs must continue to prepare a half-yearly report and publish it within 3 months. Part II UCIs must also file a long-form report with the Luxembourg Financial Sector Supervisory Commission (CSSF).

The annual report must be made available to the competent authority in the home member state of the AIFM and, where applicable, the home member state of the AIF. This means, for example, that the annual report of any non-Luxembourgish AIFs managed by a Luxembourgish AIFM would need to additionally be filed with the CSSF.

For non-EU AIFMs marketing under the national private placement regimes in the EU, the annual report of the AIF must be made available to the local EU regulator of the target market.

Each AIFM needs to identify their obligations based on their marketing and management activities and the transitional arrangements they may be able to avail of, subject to national rules.

The deadline for the publication of the annual report of an AIF is within 6 months of year-end.

AIF annual report requirements

Set out below is a summary of the new requirements impacting the AIF's annual report when the AIFM is required to comply with Article 22 of the AIFMD on the annual report.

AIFMD will require changes to the way gains and losses are presented in the income and expenditure account.

Presentational changes to the income and expenditure account:

AIFMD will require changes to the way gains and losses are presented in the income and expenditure account. This could lead to the inclusion of four separate line items in respect of gains and losses, which is in contrast to the current requirements under both laws and regulations applicable to the preparation of annual accounts in Luxembourg (LUX GAAP) and IFRS.

A literal interpretation of the rules would suggest that separate line items for realised gains on investments and unrealised gains on investments are to be included under income and likewise, both realised and unrealised losses on investments are to be separately included under expenses and on the face of the income and expenditure account. However, industry practice may evolve to present this information by way of note instead, such that the presentation under existing accounting standards prevails.

Remuneration:

The remuneration disclosure must be made in the annual report of each AIF managed and there is some flexibility in terms of how this should be disclosed. Remuneration for the entire AIFM may be disclosed but there is a requirement to break information down by AIF insofar as this information exists or is readily available. A description of how the allocation or breakdown has been done should be included.

The AIFM must disclose the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, indicating the number of beneficiaries and, where relevant, carried interest paid by the AIF. The AIFM should indicate whether the remuneration disclosure relates to any of the following:

1. Total remuneration of the identified staff of the AIFM indicating the number of beneficiaries
2. Total remuneration of those staff of the AIFM who are fully/partly involved in the activities of the AIF indicating the number of beneficiaries
3. The proportion of the total remuneration of the staff of the AIFM attributable to the AIF and the number of beneficiaries (pro rata allocation)

The annual report must also disclose the aggregate amount of remuneration of senior management and members of staff of the AIFM "whose actions have a material impact on the risk profile of the AIF".

An AIFM must disclose general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created. The disclosures must be sufficient to provide an understanding of the risk profile of the AIF and the measures to avoid/manage conflicts of interest.

The remuneration disclosures in the annual report are distinct from ESMA's "Guidelines on sound remuneration policies under the AIFMD" ("ESMA's Guidelines"). Therefore, in the absence of further clarification from the CSSF, the look-through applied under ESMA's Guidelines to delegates may not necessarily apply beyond the entity acting as AIFM in the context of the annual report remuneration disclosures and each AIFM will need to determine the approach based on its own circumstances. The remuneration disclosures may be included in the unaudited section of the annual report.

Remuneration for the entire AIFM may be disclosed but there is a requirement to break information down by AIF insofar as this information exists or is readily available.

Does the remuneration disclosure requirement apply for the first reporting period in which an AIFM is authorised?

A key question that has arisen is whether the remuneration disclosures in the annual report apply for the reporting period in which an AIFM is authorised (or registered under private placement). ESMA clarified in their Q&A on the application of the AIFMD (updated 17 February 2014) that although the AIFMD remuneration rules start applying as of the date of authorisation, the variable remuneration rules would only apply to the first full performance period after an existing AIFM becomes authorised, e.g. 2014 for an AIFM whose accounting period ends on 31 December and which obtained an authorisation between 22 July 2013 and 31 December 2013. ESMA's Q&A further clarifies that for an existing AIFM whose accounting period ends on 31 December which submits an application for authorisation by 22 July 2014 and obtains an authorisation after that date (including when the authorisation is obtained after 31 December 2014), the AIFMD rules on variable remuneration should apply to the calculation of payments relating to the 2015 accounting period.

ESMA remuneration statement

ESMA's Guidelines include additional remuneration disclosure requirements, based on the Commission Recommendation 2009/384/EC on remuneration policies in the financial services sector. This disclosure goes beyond that contained in the Directive and includes information on decision-making procedures and criteria for pay and bonuses. AIFMs must assess the extent to which this disclosure is relevant to them and may apply proportionality in relation to the level of information disclosed. The disclosure should be published on at least an annual basis to relevant stakeholders. The disclosure may be made through an independent remuneration policy statement, a periodic disclosure in the annual report or through any other form.



Risk management:

AIFMD requires enhanced disclosures in relation to risk management as part of the periodic reporting which could be addressed by way of the annual report. These disclosures include:

- The current risk profile of the AIF
- The main features of the risk management systems employed to manage those risks
- Any change in those systems and its impact on the AIF and investors
- Measures to assess the sensitivity of the AIF's portfolio to the most relevant risks
- Any breaches/likely breaches of risk limits, the circumstances surrounding same and remedial measures taken.

Material changes in respect of the current risk profile of the AIF and the risk management systems employed by the AIFM should be disclosed in the annual report.

Liquidity arrangements:

Information on liquidity arrangements must be provided in advance of investment as well as periodically. The periodic reporting on liquidity arrangements could be addressed by way of the annual report of the AIF. The following should be disclosed in a clear and understandable manner:

- The percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature (calculated as the net value of those assets divided by the NAV of the AIF)
- An overview of these special arrangements and any changes thereto
- The valuation methodology applied
- Management and performance fees applied to these assets
- Any material changes made to the liquidity management systems and procedures (does not apply to unleveraged closed-ended AIF)
- Any gates, side pockets or suspension of redemptions invoked
- The terms and circumstances under which redemption is permitted and when management discretion applies
- Any voting/other restrictions exercisable
- Duration of any lock up provision
- Any first in line or prorating provisions applied in respect of gates and suspensions of redemptions



AIFs that prepare their annual report in accordance with LUX GAAP may face significant additional disclosures.

Material changes in respect of the following should be disclosed in the annual report:

- The description of the AIF's liquidity risk management
- Redemption rights in normal and exceptional circumstances
- Existing redemption arrangements

Leverage:

Leverage disclosures should be made as part of the regular and periodic reporting requirements and in the prospectus of the AIF under the pre-investment disclosure requirements. The periodic reporting could be addressed by way of the annual report. The following should be disclosed in a clear and understandable way:

- Any changes to the maximum level of leverage calculated in accordance with the gross and commitment methods
- The original and revised maximum leverage (calculated as relevant exposure divided by the NAV of the AIF)
- The nature of rights granted for the reuse of collateral
- The nature of any guarantee granted under the leveraging arrangement
- Total leverage employed by the AIF calculated in accordance with the gross and commitment methods
- Details of changes in service providers relating to one of the items above

Material changes in respect of the following should be disclosed in the annual report:

- The circumstances in which the AIF may use leverage
- The types and sources of leverage permitted and the associated risks
- Any restrictions on the use of leverage and any collateral and asset reuse arrangement
- The maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF

Investor disclosures and material changes:

AIFMD lists a wide range of investor disclosures under Article 23 to be made prior to investment. These disclosures should generally be made in the prospectus, while in some cases it may be appropriate to include them in the annual report as part of the periodic or regular reporting requirements, as outlined above in relation to risk management, liquidity and leverage. "Material changes" to any of the disclosures under AIFMD's Article 23 must be addressed in the annual report. A list of potential material change disclosures arising from AIFMD is included in the appendix to this briefing. The disclosures may be included in the unaudited section of the annual report.

What is a material change?

A "material change" occurs "if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF". Luxembourgish non-UCITS funds already had to disclose material changes to the prospectus that impacted the annual report, so this requirement should not present a major change but consideration needs to be given to any potentially new areas of disclosure under AIFMD versus requirements under the existing non-UCITS rules. The disclosure requirements in respect of material changes may be completely new to offshore funds marketing in the EU under AIFMD.

Activation of gates and side pockets requires immediate notification in addition to disclosure in the annual report.

Time sensitive information

For time sensitive communication of information, other channels, such as email communications, factsheets or newsletters should be considered in addition to disclosure in the annual report. This will depend on the nature of the change, e.g. activation of gates and side pockets requires immediate notification, in addition to disclosure at time of issue of the annual report. Changes in risk and leverage information and depositary liability are also more time sensitive.

Report on the activities of the financial year

The annual report of AIFs must contain a report on the activities of the financial year. This report on the activities must now include, as a minimum, the following:

- An overview of the AIFs investment activities and performance over the period as well as its period-end portfolio
- Disclosure required on material changes under Article 23 of AIFMD if not presented elsewhere in the annual report

The report must present a fair and balanced review, including a description of the principal risks and investment or economic uncertainties faced. Both financial and non-financial key performance indicators should be used to the extent necessary for users to gain an understanding of the AIFs investment activities and performance. The information in this report shall form part of the investment managers or directors report where these are presented alongside the financial statements of the AIF.

Sub-threshold AIFMs

AIFMs falling below the regulatory AuM thresholds of €100 million or €500 million (unleveraged with a 5 year lock-up period) and which choose not to opt-in under the AIFMD are subject to only limited disclosure and regulatory reporting requirements under Article 3 of AIFMD and not the annual report or transparency requirements under Articles 22, 23 and 24. However, there may be annual report requirements at member state level, which is the case for sub-threshold AIFMs managing Part II UCIs, specialised investment funds (SIFs) and risk capital investment companies (SICARs) in Luxembourg. Under the respective product laws these Part II UCIs, SIFs and SICARs managed by sub-threshold AIFMs (also referred to as “Registered AIFMs”) which choose not to opt-in under the AIFMD must file an annual report which includes:

- A balance sheet or a statement of assets and liabilities
- A detailed income and expenditure account for the financial year
- Report on the activities of the financial year, as well as
- Any significant information enabling investors to make informed judgement on the development of the activities and results

The annual report of AIFs exercising control of non-listed companies

The annual report of such AIFs or the annual report of the respective non-listed companies must include at least a fair review of the development of the company’s business representing the situation at the end of the financial period and also indicate:

- Any important events that have occurred after the financial period-end
- The company’s likely future development, and
- Information relating to the acquisitions of own shares

Appendix – potential material changes under Article 23

Material changes in respect of the following items should be disclosed in the annual report:

Delegated management function:

- The description of delegated management functions
- Any safe-keeping function delegated by the depositary
- The identification of the delegate and any conflicts of interest that may arise from such delegations

Investment strategy:

- The investment strategy and objectives
- The types of assets in which the AIF may invest
- Information on where any master AIF is established and where underlying funds are established if the AIF is a fund of funds
- The techniques the AIF may employ and all associated risks
- Any applicable investment restrictions
- A description of the procedures by which the AIF may change its investment strategy or investment policy, or both
- The circumstances in which the AIF may use leverage
- The types and sources of leverage permitted and the associated risks
- Any restrictions on the use of leverage and any collateral and asset reuse arrangement
- The maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF

Contractual and service arrangements:

- Changes to the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, on the applicable law and on the existence or not of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established
- The identity of the AIFM, the AIF's depositary, auditor and any other service providers and a description of their duties and the investors' rights
- How the AIFM is complying with the professional negligence cover requirements

Valuations:

- The description of the AIF's valuation procedure
- The methodology for valuing assets, including hard-to-value assets

Liquidity risk management

- The description of the AIF's liquidity risk management
- Redemption rights in normal and exceptional circumstances
- Existing redemption arrangements

Investor treatment

- All fees, charges and expenses and maximum amounts thereof, borne by investors either directly or indirectly
- The description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment
- The description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic links with the AIF or AIFM
- The procedure and conditions for the issue and sale of units or shares of the AIF

Prime broker and depositary relationship:

- The identity of the prime broker and the description of any material arrangements of the AIF with its prime brokers
- The way the conflicts of interest are managed
- The provision in the contract with the depositary on the possibility of transfer and reuse of AIF assets
- Information about any transfer of liability to the prime broker that may exist
- Any arrangement made by the depositary to contractually discharge itself of depositary liability
- Any changes with respect to depositary liability

Periodic and regular disclosures:

Any material changes in respect of the provision of periodic disclosures covering liquidity and risk management under Article 23.4 and any material changes in respect of the provision of regular disclosures relating to leverage under Article 23.5 (see above).



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