



The
Transparency
Provisions of
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Introduction

Directive 2011/ 61/EU on Alternative Investment Fund Managers (the “Directive”), which was agreed by the European Parliament on 11 November, 2010 was finally adopted on 21 July, 2011. Member States have until 22 July 2013 to implement its provisions. **Readers should note that at the date of publication, Level 2 Commission Regulation on implementing the Directive has not yet been published in final form, and all information in this document is subject to change, following such publication.**

One of the main objectives of the Directive is to increase transparency around the activities of Alternative Investment Fund Managers (“AIFMs”) and their Alternative Investment Funds (“AIFs”) in their dealings with investors and competent authorities. The Directive deals with provisions on transparency in three sections, Article 22, which deals with the Annual Report of an AIF, Article 23, which deals with Disclosure to Investors, and Article 24, which deals with Reporting Obligations to Competent Authorities.

Set out below is a brief consideration of each of these provisions as set out at Directive level, and as discussed further by ESMA in its technical advice to the European Commission on possible implementing measures of the Directive.

Annual Reports

An AIFM is required to produce, for each of the AIFs it manages, and for each of the AIFs it markets in the EU, annual reports (“Annual Reports”) which must be:

- (a) made available no later than 6 months post financial year end;
- (b) provided to investors on request; and
- (c) made available to competent authorities of the home member state of the AIFM and, where applicable to the competent authorities of the home member state of AIF.

ESMA acknowledges the number of national and international accounting standards that set out prescriptive rules for annual reports, seeks to avoid applying rigid rules or templates around this and recommends as a general principle, that all information provided in the annual report must be presented in a manner that provides materially relevant, reliable, comparable and clear information that investors may need in relation to particular AIF structures.

Content of Annual Report

The Directive prescribes certain minimum standards to be met in the content of the annual report, as follows:

- (a) balance sheet/statement of assets and liabilities;
- (b) income and expenditure account for financial year;
- (c) report on activities of the financial year;
- (d) any material changes during the financial year;
- (e) total amount of remuneration paid to AIFM staff for the financial year (fixed and variable) number of beneficiaries, and any carried interest; and
- (f) the aggregate remuneration broken down by senior management and staff of the AIFM whose actions have a material impact on risk profile of the AIF.

For the purposes of (c) above, ESMA advises that at least the following elements be included:

- (a) an overview of investment activities during the year and overview of AIF's portfolio at period end;
- (b) overview of AIF performance over the period; and
- (c) material changes in the information disclosed.

The accounting information in the annual report must be audited and prepared in accordance with accounting standards of the home Member State of the AIF, or of the third country where the AIF is established and with the accounting rules laid down in the AIF own rules of incorporation.

The report should also include a "fair and balanced" review of the activities and performance of the AIF, and description of principal risks and investment or economic uncertainties that the AIF may face. Where necessary, analysis should include both financial and (where applicable) non-financial key performance indicators relevant to the AIF. This disclosure should not seek to make public any proprietary information of the AIF.

Disclosure of "Material Changes"

A "material change" means "changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF".

For the purposes of compliance with paragraph (d) of “Content of the Annual Report” above, ESMA advises that the AIFM must assess changes in the information to be disclosed. Such information should be disclosed in line with accounting standards requirements. Where information is not covered by the accounting standards, a description of the material change should be provided together with any potential or anticipated impact on the AIF and its investors. In either case, where the information is already made available to investors, cross reference should be made to the medium where such detailed information is available.

Content and Format of Remuneration Disclosure

The information concerning remuneration as contained in the annual report must contain information on the total amount of remuneration for the financial year, split into fixed and variable components.

ESMA also advises that the annual report should specify whether the total remuneration disclosed, (which should also mention the carried interest paid by the AIF), relates to:

- (a) the total remuneration of the entire staff of the AIFM, with an indication of number of beneficiaries;
- (b) the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF with an indication of the number of beneficiaries; or
- (c) the proportion of the total remuneration of the staff of the AIFM attributable to the AIF and an indication of the number of beneficiaries.

ESMA further advises that where the above information is disclosed at the level of the AIFM, that an allocation or breakdown should be provided in relation to each AIF, insofar as this information exists or is readily available. Proportionality should be used in the application of this requirement to avoid situations where for smaller AIFM, disclosure of information would in effect identify the remuneration of an individual member of staff of that AIFM. Further, the aggregated amounts broken down by senior management and those members of staff whose professional activities have a material impact on the risk provide of the AIF should be disclosed unless any such disclosure would be in breach of the requirements of the Data Protection Directive or other legislation.

ESMA suggests that this could be achieved through disclosure of the following:

- (a) total AIFM remuneration data split in fixed and variable components;

- (b) a statement that this data relates to the entire AIFM, and not the AIF;
- (c) the number of AIF and UCITS (if any) funds managed by the AIF; and
- (d) the total AUM of such AIFs and UCITS with an overview of the remuneration policy and a reference to where the full remuneration policy of the AIFM is available at the request of investors.

Further context may be provided by disclosure of the total variable remuneration funded by the AIF through payment by it of performance fees or carried interest, as the case may be. ESMA also states that in addition to remuneration disclosure, it may be appropriate for AIFM to provide information relating to the financial or non-financial criteria of the remuneration policies and practices for relevant categories of staff, to enable investors to assess incentives created.

Disclosure to Investors

The Directive requires that a certain minimum level of information is made available to investors in AIFs marketed within any member state of the EU. Such information must be made available to investors prior to any investment, and on an on-going basis, ESMA does not advise on the general mechanics of how this should be made available.

Information to be Made Available To Investors

The minimum level of information to be made available in accordance with the Directive must include a description of the following:

- (a) the investment strategy and objectives of the AIF, where any master or underlying fund is established, the types of assets in which the AIF may invest, techniques employed and associated risks, investment restrictions, use of leverage (including types and sources of leverage permitted and maximum leverage permitted) and collateral and asset reuse arrangements;
- (b) the procedures by which the AIF may change its investment strategy and/or policy;
- (c) the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, applicable law and the

- existence or not of any legal instruments providing for the recognition and enforcement of judgements in the territory where the AIF is established;
- (d) the identity of AIFM, and the AIF's depositary, auditor and other service providers and a description of their duties;
 - (e) how the AIFM is complying with the requirement to cover professional liability risks;
 - (f) any delegated management function relating to investment management functions and any delegation of safekeeping function by the depositary, the identity of the delegate and any conflicts of interest from such delegation;
 - (g) valuation procedures, pricing methodology, methods used in valuing hard to value assets;
 - (h) the AIF's liquidity risk management, including redemption rights in normal and exceptional circumstances and existing redemption arrangements;
 - (i) fees, charges and expenses and the maximum amounts thereof borne directly or indirectly by investors;
 - (j) how fair treatment of investors is ensured by the AIFM, details of any preferential treatment, the type of investors who obtain such preferential treatment and their legal or economic links with AIF or AIFM;
 - (k) latest annual report;
 - (l) the procedure and conditions for issuing units;
 - (m) the latest NAV of AIF or latest market price of unit;
 - (n) the historical performance of AIF;
 - (o) identity of prime broker and any material arrangements and a description of how conflicts of interest are managed, description of the provision in the contract with the depositary and the possibility of transfer and reuse of the AIF assets, and information about any transfer of liability to the prime broker that may exist;

- (p) how and why information required regarding special arrangements or leverage (see further discussion below) is disclosed

In addition to the above, the AIFM must inform investors before investment in the AIF (although the Directive does not prescribe how such information should be provided) of any arrangement made by the depositary to contractually discharge itself of liability. Any changes to depositary liability must be notified to investors without delay.

Information to be made Available by AIFMs

AIFMs are required to periodically disclose to investors for each EU AIF that they manage, and each AIF marketed by them in the EU:

- (a) *the percentage of AIF assets which are subject to special arrangements due to their illiquid nature;*

ESMA advises that the percentage of AIF assets which are subject to special arrangements should be disclosed as part of the AIF's periodic reporting to investors, and at a minimum, in the annual report of the AIF. This disclosure should contain an overview of any special arrangements, including valuation methodology applied to the special arrangements and how management and performance fees apply to these assets. By means of clarification on "special arrangements". ESMA considers that a "special arrangement" should include side pockets and other mechanisms where certain assets of the AIF are subject to similar arrangements between the AIF and its investors. However, ESMA does not believe that the suspension of an AIF should be considered to be a special arrangement as this does not constitute a separate or bespoke arrangement, rather it is an arrangement that applies to all of the assets and all of the investors.

- (b) *any new arrangements for managing liquidity of the AIF;*

Whenever an AIFM makes any material changes to the liquidity management policies and procedures adopted for monitoring the liquidity risk of AIFs (not being unleveraged closed-ended AIFs) this shall be disclosed. ESMA does not prescribe how disclosure should be made but advises that the frequency of disclosure should be consistent with the AIF's periodic reporting to investors. Further, any decisions to activate gates, side pockets or other special arrangements, or any suspension of redemptions, shall be notified immediately to investors. ESMA advises that this disclosure contain an overview of the changes to the arrangements relating to liquidity, whether special arrangements or other arrangements. Where appropriate, the AIFM should also disclose any voting or other restrictions

exercisable, the length of any lock-ups, or any rules relating to “first in line” or “pro-rating” on gates and suspensions.

- (c) *the current risk profile of the AIF and risk management systems employed by the AIFM to manage those risks.*

The current risk profile of each AIF should be disclosed as part of the AIF's obligations relating to periodic disclosure. ESMA recognises the diversity of AIF models and advises that the disclosure required of an AIFM should vary according to AIF type and depend on other factors including investment strategy and asset class. ESMA advises that these disclosures should contain measures to assess any sensitivity in the AIF portfolio to the most relevant risks to which the AIF could be exposed, or any risk limits likely to be exceeded. Where the limits are exceeded, disclosure should include a description of this, and remedial measures taken.

ESMA advises that the main features of the risk management systems employed by the AIFM should be made available to investors prior to investment, and thereafter disclosure obligations will be triggered where there are material changes to same.

Where AIFMs manage EU AIFs employing leverage or market in the EU AIFs employing leverage, they must disclose, regularly:

- (a) any changes to the maximum leverage that the AIFM may employ on behalf of the AIF as well as any right of the reuse of collateral or any guarantee granted under the leveraging arrangement; and
- (b) total leverage employed by that AIF.

ESMA advises that any disclosure pursuant to (a) shall contain the following information:

- (a) the original and revised maximum leverage level. The level of leverage should be calculated in each case as the relevant exposure divided by the NAV of the AIF;
- (b) the nature of the rights granted for the re-use of collateral;
- (c) the nature of guarantees granted; and
- (d) details of changes in any service providers disclosed in accordance with the Directive; and
- (e) the new methodology employed for the calculation of the exposure of the AIF when it impacts the level of the maximum leverage used by the AIF together with the reasons for the change in the procedure.

Reporting Obligations to Competent Authorities

AIFMs of all types are required to provide certain information on a regular basis to their home supervisors for each EU AIF they manage and for each AIF they market in the EU. ESMA recommends that the reporting frequency should depend on (i) the number of assets managed by the AIFM for information to be reported at the level of the AIFM and (ii) on the size of each fund for AIF related information, as well as based on the nature of the investment made by the AIFM.

Reporting Obligations

The Directive imposes the following reporting obligations on AIFMs to competent authorities:

1. An AIFM must regularly report to competent authorities of its home Member State on the principal markets and instruments traded by it on behalf of AIFs. The information should include the following:
 - (a) The main instruments it is trading;
 - (b) the markets of which it is a member or where it actively trades; and
 - (c) the principal exposures and most important concentrations of each of the AIFs it manages.

ESMA notes that (a) above should include a break-down of financial instruments and other assets, taking into account the AIFs' investment strategies and their geographical and sector investment focus. Further, all of the information set out in 1 above, should be provided to the competent authority as soon as possible and no later than one month after the end of the relevant period, though for a fund of funds, this period may be extended by the AIFM by 15 days.

2. AIFM must provide to its home Member State's competent authority for each EU AIF it manages and each AIF it markets within EU:
 - (a) the percentage of AIFs assets subject to special arrangements arising from their illiquid nature;
 - (b) any new arrangements for managing liquidity of AIF;
 - (c) the current risk profile of the AIF and risk management systems employed by AIFM to manage the market, liquidity, counterparty, operational, and other risks;

- (d) the main categories of assets in which AIF is invested;
- (e) the results of stress tests performed in line with the Directive.

ESMA advises that the risk profile referenced under (c) above includes (i) the market risk profile of the investments of the AIF, including the expected return and volatility of the AIF in normal market conditions and (ii) the liquidity profile of the investments of the AIF including the liquidity profile of the AIF's assets, the profile of redemption terms and the terms of financing provided by counterparties to the AIF.

3. The AIFM must, on request, provide the following documents to competent authorities of its home Member State:
 - (a) an annual report of each EU AIF and each AIF marketed in EU; and
 - (b) for end of each quarter, a list of all AIFs managed by the AIFM.
4. AIFM managing AIFs employing substantial leverage must make information on the overall level of leverage employed by each AIF it manages available to competent authority of its home Member State including:
 - (a) a break-down between leverage from borrowing and leverage embedded in FDI;
 - (b) the extent to which AIFs assets have been reused under leveraging arrangements

This information must include the identity of the 5 largest sources of borrowed cash or securities for each AIF and amounts of leverage received from each.

5. The competent authorities of a home Member State may require additional information to that required in 1-4 for monitoring of systemic risk where this is deemed necessary. The competent authority will inform ESMA about additional information requirements and in exceptional circumstances, ESMA may request competent authorities to require additional information.

The Directive also requires that the Commission adopt by means of delegated acts (taking into account the need to avoid an excessive administrative burden on competent authorities), measures specifying:

- (a) when leverage is to be considered to be employed on a substantial basis for the purpose of paragraph (4) above; and

- (b) the obligations to report and provide information provided for in the Directive.

Use of Leverage on a “Substantial Basis”

As set out above, AIFM employing leverage must make an assessment for each EU AIF it manages, and for each non-EU AIF it markets in the EU, as to whether leverage is being employed on a substantial basis.

ESMA advises that the assessment of whether leverage is employed on a substantial basis shall have regard to the following considerations, which are non-exhaustive:

- (a) the type of AIF, including nature scale and complexity;
- (b) the investment strategy of the AIFM in respect of the AIF;
- (c) the market conditions in which the AIF and AIFM operate;
- (d) whether the exposures of the AIF arising from the use of leverage by an AIFM could constitute an important source of market, liquidity, or counterparty risk, to a credit institution or other systemically relevant institution;
- (e) whether the techniques employed by the AIFM through use of leverage could contribute to the aggravation or downward spiral in the prices of financial instruments or other assets in a manner which threatens the viability of those prices; and
- (f) whether the degree of leverage employed by an AIF could contribute to the build-up of systemic risk in the financial system or risk or disorderly markets.

ESMA also advises that AIFM monitor their use of leverage on an ongoing basis and where there is material change, carry out a new assessment. The AIFM must notify the competent authorities of their home Member State of the outcome of their assessment and must provide a copy of the assessment to the competent authority on request, this will likely only need to be updated to the competent authority where such status changes. Where the competent authority considers that the AIFM is employing leverage on a substantial basis additional reporting obligations required by the Directive shall apply to such AIFM.

Summary

The implementation of the Directive will introduce pan-European standards on transparency for European AIFs and non-European AIFs marketed in Europe. The requirements of the Directive, to a great extent, mirror requirements for the existing Irish QIF product. Where changes are to be introduced, these requirements are analogous to certain requirements relating to UCITS which are now settled practice within the Irish funds industry. It is not

envisaged therefore, that compliance with the Directive's requirements around transparency will cause difficulty for Irish QIF's.

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