

Meeting the AIFMD Transparency Reporting Challenge With Confidence

Introduction

With the adoption of the Alternative Investment Fund Management Directive (AIFMD) in 2011 and its subsequent transposition into law in July of 2013, the European Union (EU) is seeking to better understand the nature, levels and concentrations of risk in the European financial system as they relate to alternative investments. Going forward, alternative investment fund managers (AIFMs) with funds established or marketed in the EU will find themselves exposed to an entirely new level of scrutiny.

AIFMD is the most significant operational challenge ever for most alternative fund managers, with a new division of labor and responsibilities, specific limitations on how funds may conduct business, and new, highly detailed reporting of their investment strategies and holdings. These detailed reporting requirements are designed to provide EU regulators with a deeper understanding of alternative financial flows, the nature and sources of risk, where such risks are concentrated, and their implications in times of market stress.

This white paper will discuss the scope and nature of the AIFMD reporting requirements for fund managers and will describe various approaches for addressing them in a timely manner.

Background

- The European Union's adoption of the Alternative Investment Fund Management Directive brings major changes to the way alternative investment funds operate. These include:
- Alternative Investment Funds (AIFs) must register and/or receive authorization to operate or market within the EU
- A depositary is used for safekeeping of assets, cash flow monitoring, and AIF unit transaction accounting
- Investment decisions must adhere to a pre-defined investment strategy
- AIFMs must provide regular detailed reporting regarding investment activities and business relationships, including:
 - Holdings and their valuations
 - Transactions during the report period
 - Use of leverage
 - Arrangements with counterparties

The vehicle for this detailed regulatory report data is called the AIFMD Transparency Report. Initial filings, covering the period from July 23, 2013, to December 31, 2013, are due by January 31, 2014. (Funds of Funds must report by February 15, 2014.)

The initial implementation of AIFMD Transparency Reporting for each AIF is expected to be substantial, with significant one-time and recurring costs. With over 400 data points to be collected, the AIFMD Transparency Report is projected to be even more complex than Form PF, its American equivalent for large hedge fund advisers (defined as advisers with assets under management of \$1.5 billion or more (\$2 billion or more for private equity funds)). The United States' Securities and Exchange Commission (SEC) estimated that such fund advisers would face a burden of as many as 300 hours¹ to produce the initial Form PF report, with the effort to produce subsequent quarterly reports estimated at 200 hours or more per year.

The AIFMD Transparency Report is a critical component of an alternative investment fund's ongoing relationships with regulatory authorities. Consequently, it is of utmost importance that the information provided in the report is thorough and that it is reviewed and approved by the various governance instances within the fund organization. This is to ensure that the report aligns with the overall message that the fund seeks to project and that a true picture of the fund's operations is presented to the authorities.

"In the beginning, there was a lot of 'Chicken Little', 'the sky is falling', 'we aren't going to be able to continue [doing business the way we have been]'", said Geoffrey Cook, a partner at Brown Brothers Harriman in Luxembourg. [But] I think the reality has been there has been a positioning that has been acceptable to the vast majority of participants." [December 5, 2013 international-adviser.com online newsletter: <http://www.international-adviser.com/news/europe/first-shock-then-denial-now-luxembourg>]

While there is an underlying desire to limit the costs and time devoted to regulatory reporting activities, it remains very important to do AIFMD Transparency Reporting right.

Key AIFMD Reporting Challenges

Producing the AIFMD Transparency Report requires the fund manager to gather a broad range of data inputs — many from outside of the fund's accounting and trading systems. Obtaining this data in a timely manner can be somewhat challenging, particularly when producing the report for the first time as the exact scope of information required and readily available is not always well understood. There are numerous calculations to be performed, many that are new and not part of typical day-to-day operations.

Why AIFMD?

In the wake of the financial crisis, the European Union ('EU') Commission made clear its intention to regulate alternative asset managers across Europe when it released its draft Alternative Investment Fund Managers Directive ('AIFMD') on 30 April 2009. The key objectives were to reduce systemic risk and enhance investor protection, with the corresponding benefit for AIFMs being a pan-European passport to provide management services and distribute funds across the EU. Voted by the European Parliament in November 2010, the AIFMD covers all alternative asset management sectors such as hedge funds, real estate and private equity, as well as traditional sectors encompassing almost all non-UCITS funds.

EY 2013 ([http://www.ey.com/Publication/vwLUAssets/AIFMD_-_Uitdagingen_en_oplossingen_2013-2014/\\$FILE/Asset_Management_AIFMD_03-04.pdf](http://www.ey.com/Publication/vwLUAssets/AIFMD_-_Uitdagingen_en_oplossingen_2013-2014/$FILE/Asset_Management_AIFMD_03-04.pdf))

¹ "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF", Securities and Exchange Commission, 2011, page 128; <http://www.sec.gov/rules/final/2011/ia-3308.pdf>

Furthermore, there is qualitative information to be gathered in addition to the quantitative. AIFMD requires much more explicit details about business relationships as well as justification of the valuations assigned to illiquid or exotic assets, thus adding to the challenge of compiling, organizing and delivering the required report contents by the deadline.

While AIFMD introduces the requirement that alternative funds define and commit to an investment strategy and perform market operations in accordance with it, it is important that the information contained in the AIFMD Transparency Report reflect and be consistent with that strategy. Consequently, a variety of internal stakeholders will be called upon to review the information contained in the report before submitting it. This requires a well-defined workflow to ensure that all necessary inputs are received from the various functional groups; to review drafts; to validate calculations and their associated assumptions and valuations; and finally, to provide the legal sign-off necessary before transmitting the report.

Once the AIFMD Transparency Report is complete, the next step is to file it with one or more regulators. AIFM's will be obliged to file two set of reports with their registered country regulator. One report at the manager level and the other at the AIF in the specific market of domicile of the fund. In some cases, modifications to the report format for transmission purposes may be required.

Once the report has been filed with the regulator, the report and the underlying data and calculations will need to be securely archived for later reference, particularly in response to audit requests by the regulator or other concerned parties.

The Manual Approach

When faced with a significant new obligation such as AIFMD Transparency Reporting, a typical response for many fund organizations is to perform the work in-house: gathering data, performing calculations, and reviewing report contents manually. With most asset managers running lean operations to begin with, fulfilling the AIFMD reporting obligation can be somewhat disruptive, particularly when it arrives on the heels of the effort to produce quarterly or year-end investor statements. Furthermore, the fact that this type of reporting and level of scrutiny is new to the world of European alternative investment fund managers means that there is often no existing reporting infrastructure similar in scope that can be leveraged and, thus, the necessary tools and processes must largely be developed from scratch², even when using a software application such as Microsoft Excel.

² Note: ESMA has developed a free template for collecting and filing AIFMD Transparency reporting data. See www.esma.europa.eu

Scope of AIFMD Transparency Report

With over 400 hundred data points to be collected, the AIFMD Transparency Report represents a massive undertaking for European alternative investment fund managers that are not used to providing detailed regulatory reports. Among the data points to be collected are:

STRATEGY

- Investment strategies
- Markets where AIFM is a member or trades
- Geographic focus
- Leverage
- Exposures

ASSETS

- Instruments
- Assets under management
- Categories of assets
- Liquidity

OPERATIONS

- Transactions and market value of trading activity
- Special arrangements and preferential treatment
- Guarantees
- Concentrations
- Collateral lending & credit support

RISKS

- Risk profile
- Risk management system(s) in place (liquidity, counterparty, operational and other risks)
- Counterparty exposures
- Stress tests

RELATIONSHIPS

- Investors
- Prime broker(s)
- Counterparties
- Funding sources

(Source: Adapted from European Union Directive 2011/61/EU and Commission Delegated Regulation (EU) No 231/2013)

A purely manual approach to meeting the AIFMD Transparency Reporting requirement has a number of drawbacks. Since most of the data required to produce the report is stored in disparate documents and often incompatible systems, there is a fair amount of time-consuming manual effort required. Key financial and transactional data must be entered by hand, holdings and valuation data reconciled, details of business relationships and commitments transcribed, calculations made and validated, and results approved by different internal stakeholders before transmission to the regulator.

Manual preparation is a brittle process with multiple opportunities for data entry errors, invalid calculation results, missed steps, or duplicated efforts due to miscommunication. Time that is spent on error checking or managing the workflow is time that is not being spent evaluating the thoroughness of the report or ensuring the coherence of the message that the AIFM wants to project to the regulator. While the manual approach is often the most instinctive, it is not truly sustainable in either the short or long term, particularly as expanded regulatory obligations are quickly becoming the norm for asset managers.

A Technology-Enabled Approach

A more sensible response to a new obligation such as AIFMD would be a scenario where the asset manager engages a technology-enabled solution provider, experienced with the exacting technical and logistical requirements of regulatory reporting, to produce and deliver the AIFMD Transparency Report.

The solution provider would manage the effort to gather, aggregate and reconcile data; calculate totals and ratios; and identify gaps or exceptions. It would provide a solution that automates a pre-defined workflow around gathering data, documenting assumptions and relationships, reviewing entries and calculations, and packaging and transmitting the report to the home country regulator.

It would offer the ability to track reviews of calculations and assumptions, as well as provide a record of approvals from a governance perspective, ultimately leading to a high level of confidence in the report's contents before they are transmitted. Such an approach would reduce the need for new business processes, for new job responsibilities, or for additional personnel, while enabling the production and transmission of the AIFMD Transparency Report by the statutory deadlines.

It would also offer support for reporting in multiple jurisdictions, including adapting to local language and technical requirements. It would address the recurring nature of reports and the need to manage multiple versions over time while leveraging existing data whenever possible. Finally, it would be designed to respond to the inevitable requests from auditors to understand the underlying numbers, calculations and assumptions.

AIFMD Transparency Reporting Readiness Checklist

1. Apply for authorization; see your National Competent Authority for specific dates
2. Identify required data types and sources
 - a. Holdings data, valuation data, and valuation justifications
3. Design processes
 - a. Data collection and reconciliation
 - b. Calculation and validation
 - c. Approvals
 - i. Who signs off, where and when
4. Compile data and other report contents
5. Calculate
6. Verify / validate calculations
7. Approve AIFMD Transparency Report contents
8. File Report with National Competent Authorities
 - a. Adapt and file with other authorities as required
9. Archive report

The benefits of such an approach, which combines elements of automation with active participation and support by a specialized external entity, are many. Whereas a purely in-house approach is largely based on best efforts, an approach that combines the efforts of the fund manager and the expertise and technology of a solution provider in a structured, well-defined and automated workflow is more likely to achieve the desired outcome by the statutory deadline. In many cases, such an arrangement will include a service level agreement whereby the solution provider makes commitments in writing. As a result, best efforts become predictable outcomes.

This approach to producing the AIFMD Transparency Report is more cost-effective as well in that no key fund personnel are left waiting for instructions. While the organization and pace of the reporting effort is largely determined by the commitments that the fund manager is prepared to make in light of existing responsibilities, the automated workflow approach is such that all participants in the process — internal and external — know when their input is most appropriate and required, minimizing disruption to the existing workload. This enables the fund manager to get back to focusing on the operations that truly define the organization and not the reporting obligations that are specific to a particular time and place. It also frees key fund personnel to focus on addressing exceptions and reviewing highlighted report elements for veracity and accuracy.

As for the automated workflow, by encoding the roles and responsibilities of both fund and solution provider personnel in software, it ensures that there are neither ambiguities nor gaps in the report preparation process. Missing data points are identified early on and flagged for treatment according to a calendar that enables delivery of the complete approved report by the deadline. The automated workflow also provides an audit trail for both internal and external review purposes.

Finally, for alternative investment fund managers that had limited need to produce such reports in the past, working with a solution provider that has experience meeting the expectations of the regulatory authorities is an effective means of reducing overall compliance risk. This type of approach maintains in-house those components of the AIFMD reporting effort that require judgment and for which the fund manager ultimately retains accountability and legal responsibility.

The Confluence AIFMD Transparency Reporting Solution

A leading provider of data automation and management solutions for the alternative investment industry, Confluence offers Unity NXT® AIFMD Transparency Reporting, a technology-enabled solution that enables asset management companies and their fund administration partners to tackle the complex AIFMD regulatory reporting challenge with confidence. Confluence's solution combines a software-as-a-service component with elements of business process outsourcing, specifically related to the production of regulatory reports such as that required by AIFMD. Features of Unity NXT AIFMD Transparency Reporting include:

- **Data gathering** — Confluence's European service team manages the effort to gather the client's data from different sources including holdings data from fund accounting systems, valuation data from 3rd party providers, and funding information from prime brokers and other counterparties. Intimately familiar with the European regulatory environment in general, and AIFMD in particular, they work with the fund manager to capture additional qualitative data such as the nature of relationships with investors, guarantors and / or other parties of interest.
- **Data scrubbing** — Confluence's dedicated data specialists scrub the underlying data for consistency of both content and presentation, facilitating its entry into the reporting engine. Unity NXT AIFMD Transparency Reporting features both an automated workflow for capturing and validating data as well as the ability to flag exceptions such as missing data or invalid calculation results or assumptions. Service level agreements for data capture and entry are available on a data source by data source basis.

- **Complex calculation** — Unity NXT AIFMD Transparency Reporting performs all of the required calculations automatically and highlights the results for review by both the Confluence data specialists and fund manager personnel. The rules driving the calculations in Unity NXT AIFMD Transparency Reporting and the overall solution have been validated by one of the Big 4 European accounting firms.
- **Automated workflow** — Unity NXT AIFMD Transparency Reporting drives the review and approval process, leveraging pre-defined user profiles to determine responsibilities for validating calculations, ensuring that gaps are corrected, and approving report content. E-mail communication and browser-based editing are used to ensure seamless integration with existing business processes.
- **Asset (AuM) monitoring** — The frequency of reporting required by AIFMD is a factor of the fund’s assets under management (AuM), ranging from no reporting required at all for a single fund with less than €500M in AuM to reporting either semi-annually (€500M to €1000M in AuM) or quarterly (more than €1000M in AuM). Based on information provided by the client, Confluence monitors each fund’s asset situation and the resulting reporting requirements on behalf of the fund manager in order to ensure that the AIFMD Transparency Report is filed (or not) as appropriate.
- **Pan-European filing** — Once complete and approved, the AIFMD Transparency Report is automatically formatted to the specific technical and language requirements of the home country regulator and transmitted electronically. It is also adapted to meet the requirements of other European National Competent Authorities where the fund has operations or marketing activities.
- **Report archiving** – After being filed with the regulator(s), the AIFMD Transparency Report is saved along with the underlying data for later reference. Each archived report features a full audit trail of changes that occurred during its preparation, including a timestamp, the nature of the changes, the new and previous values, as well as the relevant client user(s) involved in the changes.

Report Filing Frequency

Assets under Management	Frequency (1)	Deadline
Between €100 / €500 and €1 Billion	Semi-Annual	30 days
Great than €1 Billion	Quarterly	30 days or 45 days for fund of funds

AIF Type	Frequency (2)	Deadline
Unleveraged PE Funds (2)	Annually	30 days or 45 days for fund of funds

(1) Individual country regulators have the power to increase frequency

(2) Funds that invest in non-listed companies and issuers in order to acquire control

* For AIFMs with total AIF assets under management (Total AUM) of €1 billion or less, reporting requirements and frequency vary depending on total AUM, AIF size, use of leverage, and redemption characteristics

Source: Edition March 2013, PWC “Transparency and Reporting AIFMD Newsbrief”

Next Steps

Once the decision has been made to organize the fund in compliance with the Alternative Investment Fund Management Directive, the most important next step is to apply for authorization with the National Competent Authority (NCA), which is essentially the regulator for the country where the fund is domiciled. On paper, AIFs have until July 22, 2014 to register with the NCA, though in practice many regulators have imposed more aggressive deadlines to avoid a rush of applications at the formal deadline and the subsequent backlog that is expected to result.

Assuming that the AIF has already applied for authorization, the next step is to determine the AIFMD Transparency Report filing date. Generally, speaking the ESMA Draft Guidelines³ require that all AIFMs existing as of July 23, 2013 report for the first time by January 31, 2014 or by February 15, 2014 in the case of a fund of funds. The first round of reporting should cover the period July 23, 2013 to December 31, 2013. More precise details are available directly from the relevant home country regulators that are ultimately responsible for implementing the ESMA guidelines at the country level.

The next step following application for authorization is to better understand the scope of AIFMD reporting and how it affects the AIF internally, developing an appreciation for the data sources required, the calculations to be performed, the relevant disclosures, as well as the processes necessary for collecting and reporting this information in a timely manner. As we discussed, technology-enabled solutions, such as the one offered by Confluence, exist to provide a clear report creation and delivery process from the outset, something which should give the AIFM a head start on the AIFMD Transparency Reporting effort. Following the development or implementation of such a process, the AIFM should commence the effort to deliver the AIFMD Transparency Report in accordance with the required reporting date.

As of this writing, the United Kingdom's Financial Conduct Authority has granted a delay to UK-domiciled funds for becoming authorized though a new deadline has not been proposed. AIFMs are encouraged to consult with their home country regulator for the latest guidelines in this regard.

Conclusion

The Alternative Investment Fund Management Directive brings major changes in the way alternative investment funds operate in the European Union and with it a brand new set of regulatory requirements, including detailed reporting regarding investment activities and business relationships. The resulting report document, the AIFMD Transparency Report, is a critical element of the fund's ongoing relationship with regulatory authorities.

Producing the AIFMD Transparency Report requires inputs from a range of business systems and document stores, a variety of calculations specific to the report, and approval by different functional groups within the fund manager. Such an effort benefits from a well-designed workflow to ensure that the report contents are thorough and that the information contained therein presents a true picture of the fund's operations. Since regulatory compliance activities often come at the expense of fulfilling existing responsibilities, an approach to producing the AIFMD Transparency Report that limits the impact on day-to-day operations would be highly beneficial.

This can be achieved by partnering with a dedicated solution provider with expertise in the production of regulatory reports. Such a solution provider can be expected to manage the overall reporting effort, offering a pre-defined workflow centered around creating, reviewing and approving report contents, and then packaging and transmitting the report to the regulator. The principal benefit of this latter approach, which combines elements of automation with active support by a specialized external entity, is that best efforts become predictable outcomes and compliance risk is significantly reduced. Such an approach also makes sense longer term as expanded regulatory obligations for alternative investments are rapidly becoming the norm.

³ <http://www.efama.org/Publications/Public/AIFMD/EFAMA's%20Response%20to%20ESMA%20CP%20on%20AIFMD%20Reporting%20Requirements.pdf>

About Confluence

For more than 20 years the global investment management industry has come to trust Confluence to deliver innovative solutions to take the risk out of fund administration. Helping investment management companies gain unprecedented control, Confluence automates every step of the fund administration process—including the collection, creation, confirmation and delivery of investment product data. Results are lower costs, reduced risk, decreased reporting turnaround times and the scalability to automate more processes without additional resources.

Confluence solutions are used by 40 percent of the leading global investment managers, and more than 60 percent of U.S. mutual funds. From the Confluence traditional install, hosted and outsourced Unity® platform solutions to our enterprise-grade SaaS-enabled Unity NXT® Expense Processing solution; Confluence automates critical fund administration and reporting processes—such as regulatory reporting, financial statement preparation and expense processing. Confluence solutions support a wide array of collective fund investment types—including European-domiciled UCITS, alternative investments, traditional US-based '40 ACT mutual funds, and contemporary fund structures such as ETFs.

Headquartered in Pittsburgh, PA, Confluence serves the international fund industry with key locations in San Francisco, CA, London and Luxembourg. For more information, visit www.confluence.com.

References:

European Fund and Asset Management Association

- EFAMA Response to ESMA Consultation on Draft Guidelines on reporting obligations under Article 3 and Article 24 of the AIFMD
<http://www.efama.org/Publications/Public/AIFMD/EFAMA's%20Response%20to%20ESMA%20CP%20on%20AIFMD%20Reporting%20Requirements.pdf>

European Securities and Markets Authority

- Guidelines on reporting obligations under Articles 3(3)(d) and 24(1), (2) and (4) of the AIFMD, European Securities and Markets Authority.
http://www.esma.europa.eu/system/files/2013-1339_final_report_on_esma_guidelines_on_aifmd_reporting_for_publication_clean.pdf

European Union

- Commission Delegated Regulation (EU) No 231/2013
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF>
- Directive 2011/61/EU (Directive on Alternative Investment Fund Managers)
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF>

Securities and Exchange Commission

- Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF", 2011, page 128;
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