The Alternative Investment Fund Manager Directive (AIFMD) has been controversial from its first publication and it has taken more than 18 months of intensive debate and negotiation to reach a compromise text. Following publication in the Official Journal of the European Union, a two-year implementation phase to the end of 2012 will now start.

This special edition of Quicknews provides some thoughts on the likely practical impact of the Directive upon the industry and highlights difficulties that still require resolution.

**Background**

Political pressure for the regulation of Alternative Investment Funds (AIF) and their Managers (AIFM) prompted the European Commission to issue a draft proposal for an AIFMD on 30 April 2009. The European Parliament adopted the Directive at its plenary session on 11 November 2010. This paves the way for a formal vote at the Economic and Financial Affairs Council (ECOFIN) and then the commencement of the “Level 2” secondary rule making by the Commission and the new European Securities and Markets Authority (ESMA).

The ‘two-year’ implementation will see the secondary rules and implementation laws being drafted. It is expected that both ESMA and the Commission will consult during this process, and the hedge fund industry will need to continue to be vigilant to ensure that the agreed framework translates into sensible and appropriate measures.

The main objectives of the Directive are to extend regulation and oversight of AIFM as well as any activities that embed systematic risks. This is with the aim of improving the financial stability of the financial markets. The Directive is also intended to increase transparency toward regulators and investors, enhancing investor protection.
What does it mean?

The initial Directive contained many provisions that raised concerns amongst the investor and manager community. Most managers will be relieved that the final Directive has been significantly amended to take into consideration these concerns. However, it remains a formidable piece of legislation and has ramifications far beyond achieving tick-box compliance. While some details are still to be agreed during the secondary rule making, managers are advised to commence a review of their fund ranges and their operating models.

Service providers - specifically prime brokers, custodians and administrators - should also assess the strategic impact on their service offering and operating model, and consider how they will react to new obligations and risks introduced by the Directive.

AIFs and AIFMs will be held to different conditions under the Directive depending on whether they take advantage of existing National Private Placement Regimes (NPPRs) or the proposed “passport”, and also, depending on their domicile, investors should consider the impact of the Directive on their portfolios and their investment process.

Key impacts on the industry

The Directive will, for the first time, introduce a harmonized European regulatory regime for managers of hedge funds. From early 2013, all hedge fund managers will need to be authorized, adhere to common transparency standards and operational requirements, and utilize a new marketing regime.

1. Marketing: third country provisions

In return for more regulation, the Directive provides for the introduction in 2015 of a passport enabling managers to offer their management services and market their funds throughout the European Union under just one single authorization. However, the introduction of the passport is subject to the future review and recommendation of ESMA. Should ESMA fail to recommend the introduction of the passport, it is likely that the Commission would seek a wholesale review of the third country provisions.

In the meantime, managers will be able to rely on the existing NPPRs until at least 2018. This dual marketing regime presents managers with different conditions to be met, depending on the domicile of their AIFM or AIF.

We expect the majority of our EU AIFM clients managing non-EU AIFs to take advantage of the private placement regime for as long as possible. Such managers will have to comply with the Directive but will not have to appoint an all encompassing depositary with a high liability standard (multiple entities may be appointed).

An EU AIFM managing an EU AIF will have to comply with all provisions of the Directive from 2013. This is likely to have the unintended consequence of discouraging managers from establishing AIFMs in the EU.

Non-EU managers will also be able to rely on NPPRs. For these firms, the regulatory burden is reasonably light - they will only need to comply with the transparency requirements of the Directive (an annual report, disclosure to investors and reporting to competent authorities).

Within international groups or for multi-manager AIFs, managers will need to analyze and determine which legal entity represents the AIFM, in substance as well as form. If the manager who holds the Investment Management Agreement is a non-EU company, such as a Cayman entity, firms may need to emphasize substance and demonstrate that it is not just a “letter-box” entity. Those firms wishing to reduce their AIFMD obligations may want to move more substance to their existing non-EU company to achieve ‘non-EU manager’ status.

We should finally note some caution, as there is a possibility that Member States can alter their NPPRs to impose stricter rules than those in the Directive, in an effort to respond to perceived trends in investor protection.
2. Transparency: reporting

In order to comply with the Directive, managers must re-evaluate and potentially redefine the way in which they report to investors and competent authorities.

For example, each AIF will have to prepare an annual report disclosing the total amount of remuneration paid (split into fixed and variable remuneration paid to the AIFM’s staff) and the aggregate amount of remuneration paid to the AIFM’s senior managers and staff members whose actions have an impact on the material risk profile of the AIF. This would appear to be a complex and subjective allocation.

The reporting to competent authorities is even more onerous. There will be a requirement to report regularly data such as: the percentage of illiquid assets subject to special arrangements; the risk profile of the AIF; the management tools used to manage market, liquidity, counterparty and other risks; and the results of mandated stress tests.

For many managers, this will require a review of their reporting framework as well as their underlying data integrity and quality. They will need to ensure that the necessary information is accessible in a reliable, timely and consistent manner.

3. Functions and service providers: depositaries

Managers: those managers that are required to comply with the full Directive will be required to appoint a single independent depositary with a high liability standard for the loss of assets. The depositary will be responsible for the custody of the AIF’s assets, monitoring the AIF’s redemptions and subscriptions and other cash flows. These provisions will represent a significant incremental cost in operating alternative investment vehicles.

However, for as long as the NPPRs continue, an EU manager with a non-EU fund will not have to appoint a depository.

Prime brokers: the requirement to separate the depositary function from its counterparty function means that some prime brokers will need to reconsider their operating models, potentially having to create new legal entities or create Chinese walls. Managers should ensure that they understand the current position in relation to their prime broker and how this may affect their cash and assets held.

Custodians: there is a significant question mark over how the sub-delegate/sub-custody liability model will work in practice. The depositary will have a strict overall liability to the AIF and a responsibility to segregate and replace safe-kept assets.

4. Valuation and third-party delegation

Managers: for most managers, the requirement to have a functionally independent valuation process, with conflicts of interest mitigated, will mean the formalization and delineation of their existing valuation process. Those managers that use the expertise of the portfolio manager to mark hard-to-value assets will need to amend their processes. Under the Directive, this can be done through appointment of an external valuer responsible for pricing all assets or, if internally valued, through an independent valuation function separate from its portfolio management function.

National competent authorities will have the authority to require the valuation process to be externally verified (e.g., by an auditor).

Fund administrators/prime brokers: ‘third-party’ delegations will be subject to conditions including due diligence criteria, daily monitoring by the AIFM and the ability to withdraw the delegation with immediate effect. The practicalities of this are unclear.

Under the provisions, the third party will potentially have unlimited liability to the manager (rather than the fund) for any losses suffered through negligence or “intentional failure to perform” and this liability cannot be contracted away. There are still outstanding questions with regards to the legal position of the fund administrator since “intentional failure to perform” does not have a well-established meaning in English law.

Under the model where the prime broker acts as depositary with oversight over the valuer (administrator), there may be clarification and review required of the contractual and service level relationships in place.
5. Conduct of business: remuneration

With regards to the UK FSA’s recent Consultation Paper (CP10/19), which was geared toward the measures within CRD III, there are several overlaps between this and the AIFMD remuneration measures, which could reduce the complexity of adaptation of new legislation.

Given that one such area of overlap is the concept of proportionality, it is hoped that, should the industry be successful in persuading the FSA that the more onerous requirements of the Remuneration Code need not apply to alternative investment managers, an identical carve-out would be available under the Directive. The result of such a carve-out would mean that the deferral requirements would not be enforced on most managers.

The most important element is the consideration of fixed and variable remuneration, which should be appropriately balanced where the fixed component represents a sufficiently high proportion of the total remuneration, to allow for variable proportion to be as flexible as possible.

6. Specific provisions: leverage

The final key area for our clients is leverage. The AIFM must set a maximum level of leverage and be able to demonstrate to competent authorities that the maximum is reasonable - the criteria to demonstrate reasonableness are to be determined. If leverage is deemed to be “substantial” (again to be defined), the AIFM must make certain information available to a competent authority concerning the levels of overall leverage and the sources of leverage. Again, the AIFM will need to define a policy and framework to monitor and, if required, report the sources of its leverage on a timely basis.

Our view

Much work on the Directive still remains to translate principles into workable rules. Our recent Global Hedge Fund Survey found that the primary change investors want from the industry is more ongoing transparency over their investments. The Directive will potentially provide this transparency at the point of investment. Investors will need to continue to ask for the ongoing transparency they desire.

Our survey also found that only 40% of investors see future regulation as beneficial. We would encourage the 50% of managers who think that future regulation will not be beneficial to engage in and influence the next round of consultation.

How Ernst & Young can help

Although the Directive is in place to regulate managers, all major stakeholders will be affected, from the investors to the service providers.

Managers and funds falling within the scope of this Directive should conduct an in-depth review of their fund ranges, fund-raising process and investor base, as well as their current business model, to ensure that they are ready and able to respond to the future changes in the industry.

Ernst & Young has put together a dedicated multidisciplinary team of high-calibre experienced professionals to support managers throughout this process and to help ensure they are prepared for the imminent changes.

We can provide assistance across our assurance, tax and advisory service capabilities, including assessment of operational readiness and capability maturity modeling against the Directive’s key provisions, using the Ernst & Young AIFMD Diagnostic tool. Other services include advice on any potential entity reorganization and structuring, upgrading of risk and liquidity management controls and systems, review of depositary arrangements (risk/selection/delegation), and provision of independent valuation opinions.
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