

# *Taking stock*

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With the final directive  
agreed, it is time to assess  
the impact



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# Overview

After a year and a half of lobbying and frequently acrimonious debates, European finance ministers have agreed on a text for the Alternative Investment Fund Managers Directive (AIFMD) with representatives of the EU Parliament. Getting to this stage has been a long and difficult process, with a breakthrough only achieved by virtue of the Belgian presidency carefully steering a compromise on third country access to the EU which was finally acceptable to both the UK and France. The EU Parliament adopted the Directive on 11 November 2010 and the Directive's rules are to take effect by 2013.

Although few will be entirely happy with the final position on AIFMD, workable compromises have been reached on a number of the key issues. We are now moving into the Level 2 process of developing implementing measures, where details in many important areas will be fleshed out. The industry will need to reinvigorate its lobbying efforts over the next few months to influence the final outcome on the AIFMD regime. It is also now extremely important for managers to start, if they have not already, to examine the operational consequences on their business models. This examination will also enable identification of some of the unintended or misunderstood consequences which should be fed into the lobbying process.

The purpose of this briefing is to take stock, review the final terms of the directive, consider the next steps both in the legislative process and what the industry's response should be.

# Objectives and Result

The Directive will affect any alternative asset manager, wherever in the world it is based, seeking to raise institutional capital in Europe.

No major surprises have emerged from the final negotiations. As a quick reminder, the AIFMD's objectives are to:

- Provide a framework for management of systemic risk in the alternatives space by allowing the monitoring and managing of macro and micro prudential risks;
- Create an harmonised and stringent regulatory supervisory framework across the EU for all non-UCITS fund managers;
- Ensure enhanced transparency and investor protection;
- Facilitate marketing of alternative investment funds ("AIFs") to professional investors throughout the EU – "EU Passport" for AIFs; and
- Regulate the marketing of non-EU AIF to professional investors throughout the EU.

Against these objectives, the negotiated AIFMD provides as follows:

- **Scope:** all asset managers with more than Euro 100m geared

or Euro 500m ungeared under management (aggregated) will be subject to regulation and be required to maintain potentially significant amounts of regulatory capital. *(Across Europe and across asset classes, many managers not previously caught will be, and will need to fund a regulatory capital requirement of at least Euro 125,000. Even small managers managing small exempt funds will face registration and reporting requirements.)*

- **Investors:** the Directive seeks to limit marketing of funds mainly to "MiFID professionals" but individual member states will have the flexibility to allow categories of AIF to be marketed to retail investors within their countries. *(The AIFMD passport will only be available for marketing cross border to professional investors.)*
- **Transparency and Disclosure:** managers' processes and internal reporting and external reporting to investors and regulators across a wide range of business areas will need significant enhancement. *(Gearing, liquidity and risk management, trading activity and, for those in the PE space, information about and from portfolio investments will be more visible and under much more scrutiny.) (Valuation functions will need to be robust and have high degrees of operational independence.)*
- **Asset stripping:** for private equity managers, an unlevel playing field remains, with a 24 month post-acquisition ban

imposed on distributions, capital reductions, share redemptions and acquisition of own shares by portfolio companies after an AIF acquires control (*Control is 50% or more of the voting shares in the target.*)

- **Depositories:** while the precise quantum and scope of depository liability remain to be agreed in the Level 2 implementing measures, the range of responsibilities of custodians and depositories is significantly increased. (*Managers and service providers will need to re-engineer their contractual relationships and systems, and service providers will need to revamp their offerings. Custodial services are likely to cost more and some AIFM will need to appoint custodian service providers for the first time. For Hedge Fund managers, the PB business model, which has been the subject of so much re-engineering over the last 18 months will again need adjusting to take account of the new custodian relationship and relative responsibilities.*)
- **Delegation:** significant incremental constraints arise around delegation and the roles and responsibilities of providers and those who are outsourcing functions, particularly in relation to fund management services;
- **Reward:** reward and remuneration structures will need to change. (*Severe constraints are proposed over the nature and timing of reward, derived from the banking model.*)

With at least 48 subsidiary pieces of technical guidelines, rule making, interpretation and review to follow, much more detail on AIFMD will emerge over the coming months.

### Third Country Measures

With regard to the “Third country debate” which was the battle ground for the fiercest arguments, the final compromise is not as bad as was initially anticipated and is a substantially better result for industry than some of the earlier drafts:

- From 2013 until 2018 existing country by country private placement rules governing distribution of non-EU funds throughout the EU will remain in place (i.e. the status quo) subject to:
  - non-EU managers’ funds complying with certain disclosure and reporting requirements and, in the private equity space, complying with the anti-asset stripping rules,
  - non-EU managers managing EU funds being registered with a Member State competent authority;
  - EU managers running off-shore funds appointing a “quasi” depository, and
  - Regulatory cooperation agreements being in place between the non-EU domicile of the manager or fund and the Member State into which the fund is to be sold;

- From 2015, a parallel passport regime will be introduced, which will permit non-EU funds to be distributed on a pan-EU basis, provided certain criteria are met; and
- In 2017, ESMA, the new European Securities Markets Authority will review the operation of the private placement regime and determine whether it recommend it be continued or terminated.

The criteria or conditions that third countries and managers located there will be required to meet under a passport regime are yet to be finally established. However, such conditions are likely to include:

- existence of appropriate regulator to regulator cooperation agreements;
- appropriate anti-money laundering and anti-terrorist financing laws and regulations in the third country;
- a network of OECD model tax information exchange agreements with EU member countries; and
- full compliance, to the extent legal, by a local manager with the AIFMD regime and “authorisation” by that manager with a member state of reference for the purposes of supervision of EU focused activities.

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## Where does this leave the asset management industry?

Although less dire than initially feared, the AIFMD nevertheless still represents a game changing alteration to the business environment for the global asset management industry, bringing alternative funds and their managers clearly and unambiguously into the regulatory net.

EU resident managers will need to re-consider the strategies and fund products they want to pursue in the future, having regard to the narrowing of the classes of eligible investors, the likely erosion in due course of the private placement regime and the increases in operating costs which will flow out of the AIFMD. In addressing these issues, managers also need to take account of the massive burden of other changes on the regulatory horizon and which will alter the ways (and costs) of doing business (e.g. the Dodd-Frank Act, MiFID II, UCITS V, CRD III, RDR, FATCA – the list goes on).

Once the strategic issues have been addressed, EU managers will need to act quickly to address material operational changes arising from their strategic decisions and the additional regulatory burdens imposed by AIFMD, working to identify the gaps and/or areas that require change from their current operating model.

For EU Managers with off-shore funds, more material structural issues will need to be thought through – including the necessity to appoint a custodian, which will alter structures, contractual arrangements and costs.

For non-EU managers running off-shore funds, the retention of existing private placement rules until at least 2018 (and possibly thereafter) represents substantially a continuation of the status quo, subject to meeting the requirements mentioned above (of which the most onerous fall on private equity managers). However, non-EU managers cannot afford to be complacent regarding product strategies, as the evolution in on-shore funds will inevitably impact the marketability of their products in the EU. Indeed some non-EU managers may determine that the transparency and disclosure provisions placed on them are so heavy that they will cease to market in Europe and may simply rely on “passive marketing”.

It is clear that there is a lot to be done.

## So, what next?

The political process is not over. With the debate over the fine detail of the implementation moving away from the Council of Ministers and the European Parliament to the committees of the Commission and ESMA, industry should not lose sight of the need to lobby to ensure the detail is appropriate and unintended consequences avoided. Previous lobbying has clearly paid off as some of the most contentious proposals have been removed or watered down in the latest text. Although the delay and consequent uncertainty has deterred some fund managers from raising new money, the position finally agreed is a substantial improvement on some of the earlier proposals, due to very active lobbying.

Managers should now embark on two parallel processes:

- First, proactively engage in the lobbying process - for UK managers and investors, these efforts should not be confined to lobbying through national trade associations, but should also be extended to other countries if possible, where particular managers have operations or investments. Influencing as many national regulators as possible is critical. All managers, custodians, other service providers, administrators and investors who will be adversely affected should lobby their regulators and MEPS, who will have a voice and who may well be material beneficiaries of inward investment through, for

example, private equity firms or real estate funds. They therefore can be motivated to be voices for industry in the debates which will be getting underway as soon as the Parliamentary dust has settled.

Managers are not the only constituency for which lobbying should be on the agenda. The impact of AIFMD on investors will be material and some of its potentially worst effects are still capable of being ameliorated in the rule making to follow. Accordingly, investors with a long term commitment to the alternatives sector who have the resources to do so should also actively engage in the lobbying process and managers need to be ready to have answers for their investors on how they propose to respond to the Directive's challenges.

- Second, begin upgrading internal management and controls, revamping remuneration structures and re engineering fund structures and relationships to accommodate the AIFMD's requirements - every EU domiciled manager, running an EU domiciled fund must have an independent custodian. The custodians' new role makes them directly liable to investors and charges them with performance of a great variety of different functions, many of which had previously fallen within the managers' remit or have been dealt with by administrators, under contract.

The imposition on managers of material new organisational costs and the re-engineering of custodian relationships, with high levels of liability being imposed on these entities will not come cheap either in terms of cash or human resources.

# Conclusions

AIFMD represents a major challenge and it is coming soon – for many players it will offer opportunities to gain a competitive advantage. Getting ready for AIFMD requires all industry participants, but especially managers, to start taking action now.

The key issues which managers need to address quickly are to ensure that they:

- Carry out a gap analysis to determine the impact of AIFMD on their organisations now, including significant functions that are outsourced, and start to evaluate the necessary changes to their organisations and functions to ensure they will be compliant by, at latest, the end of 2013;
- Identify custodians (or entities which will be willing to act as custodian if they don't already have one) and prime brokers and what changes to the agreements with them are going to be necessitated by the new functions which custodians are being required to perform, the liabilities they are being required to assume and the prime broker's role as defined in AIFMD;
- Estimate the incremental costs of the changes to their organisations and fund structures, and how those costs and the other changes are to be managed and communicated to investors;
- Evaluate the impact of AIFMD on their organisation's existing remuneration structures and policies;
- For firms which have off-shore funds and managers located outside the EU, evaluate the potential routes to market, whether they will seek a passport and how the conditions which will need to be satisfied to permit those funds to continue to be sold into the EU;
- Understand whether there are operational advantages to moving (where possible) to UCITS wrapped structures; and
- Assess the demographics of their investor bases, to identify whether there are categories of investor who will no longer be eligible to invest and who will need to be replaced.

We will see crucial Level 2 rule making produced by the EU over the next few months. Managers should be starting to get their own houses in order and stepping up their lobbying efforts as the debate moves away from ministerial and parliamentary discussion into working Committees. Managers have the ability to influence the final rules and real progress can be made to ensure the final AIFMD rules facilitate effective marketing and reflect operational realities.

For our part, PwC will continue actively to engage in the debate and looks forward to working with managers and service providers to help them evaluate the strategic impacts of AIFMD (and the other regulatory changes coming) and to prepare for compliance.

# Contacts

If you would like to discuss any of the areas covered in this paper as well as the implications for your business, please speak with your local PricewaterhouseCoopers contact or one of our AIFMD specialists listed below:

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