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The lull before the storm

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A delay to AIFMD's legislative progress should not be seen as a reason to delay preparations for its impact – industry needs to take action now

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Two recent announcements serve as timely reminders that the Alternative Investment Fund Managers Directive (AIFMD) continues its legislative progress and that alternative asset managers and service providers need to be analysing now its impact on their businesses and start preparing for impact as they plan for the next few years.

The European Commission (EC) has pushed back the response date for the advice from the European Securities and Markets Authority (ESMA) to November 2011. In addition, Switzerland's Federal Council in Berne (Federal Council) has urged legislators and regulators to begin preparing for AIFMD. These two announcements clearly indicate that at government and regulatory level, AIFMD and its progress remain a major component of the ongoing programme of financial services reform, both within the EU and internationally. Indeed, the UK FSA has already started querying directly with UK firms their readiness for the directive.

EU delay

At the end of February the EC wrote to the acting head of ESMA advising that, due to the immense legislative workload, AIFMD would not officially enter the European Statute Books until June of this year. Therefore, recognising ESMA's similarly significant workload in responding to the technical request for advice from the EC, ESMA will not be required to deliver its formal advice until 16 November 2011, two months later than originally planned.

Level 2 Committees Hard at Work

Within the EU, regulators have publically recognised that getting ready for the directive is a major task and that preparing the detailed Level 2 Directives and Regulations will stretch available resources. The financial services regulators of France, Germany, Ireland and the UK chair four working groups dealing respectively with:

- depositary issues (the AMF in France);
- authorisation and general operational requirements, including delegation (BaFIN in Germany);
- scope, defining categories of managers and strategies and defining opt-in and opt-out conditions (the Central Bank of Ireland); and
- transparency, risk, leverage and liquidity (the FSA in the UK).

Their primary goal is to assist ESMA in defining its recommendations to the EC, which will shape Level 2 legislation to be appropriately responsive to the Level 1 text. They must also ensure that the measures are capable of implementation at a practical level across the great diversity of fund structures and asset management business models (including both EU and offshore arrangements). Each of the four committees has a spread of participants from other EU regulators, and is working hard to complete its work in the allocated time, with each already having held several meetings. However, they all recognise that they have an immense amount of work to do to provide clear advice to ESMA.

The Swiss Response to AIFMD

The Federal Council has formally instructed the Federal Department of Finance (FDF) to draft legislation amending the Swiss Collective Investment Schemes Act. This would bring the regulation of managers of unregulated funds in Switzerland in line with international developments, and in particular ensure access to the EU market for Swiss managers. While this reaction will likely be echoed by a majority of the so-called 'third countries' close to the EU, keen to ensure their managers do not find themselves at risk of exclusion from the EU marketplace, it remains to be seen how off-shore jurisdictions not dependent on the EU react.

The Federal Council noted that AIFMD would raise the bar for non-EU asset managers seeking to market alternatives products in the EU, and went on to add:

"Unlike in the EU, the distribution of foreign collective capital investments to qualified investors is not regulated in Switzerland. Moreover, there is no binding subjection obligation for the asset managers of foreign collective capital investments. Against this backdrop, there is the risk that Switzerland would become the centre of attraction for products and financial service providers that do not want to be subject to the more stringent EU regulations. The legislative amendments targeted by the Federal Council should enhance investor protection, increase the quality of asset management in Switzerland, and maintain access to the EU market for Swiss service providers.

The Federal Council has instructed the FDF to prepare a consultation draft by summer 2011"

Traditionally, Switzerland has been home to much private banking activity and many fund managers offering investment products to both high net worth individual and institutional investors. The Federal Council's instruction demonstrates a clear realisation that the effect of the "third country provisions" of AIFMD on Swiss businesses might be to close off access to significant client bases unless Swiss regulation is brought more into line with new European rules. If these legislative changes are not made, Switzerland would not be able to enter into the required co-operation agreements with EU regulators before AIFMD comes into effect in June 2013, preventing Swiss resident managers from continuing to sell their products into the EU.

Asset Manager Responsiveness

While the regulators are clearly making progress on AIFMD, businesses are not demonstrating equivalent engagement. At a recent conference in Luxembourg, asset managers and their service providers demonstrated a worrying lack of awareness about the potential impact regulatory changes will have on their businesses.

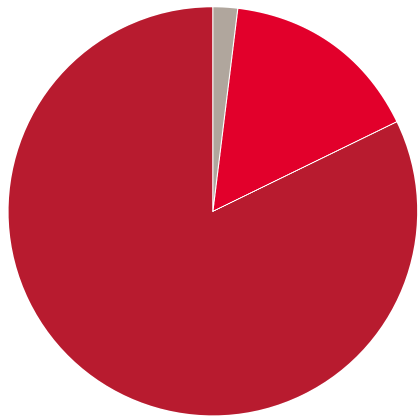
According to a survey of some 180 industry participants taken at the International Transfer Agency Summit (ITAS) in late February, 67 per cent rated their understanding of AIFMD as poor. The funds industry appears to be struggling to grasp the changes that will be felt once AIFMD is in force. As illustrated opposite, 82% of respondents to the ITAS poll also admitted they have not yet made any assessment of its potential impact, with only 2 % having put in place a plan for implementation.

A separate poll also revealed that 88 per cent felt unprepared for its implementation, while 81 per cent said they still required more information on the directive itself.

A certain level of detachment from AIFMD is understandable, particularly given all the other regulatory changes with which managers are coping. For example, the US registration requirements resulting from the Dodd Frank legislation present a "burning platform" demanding immediate responses with the July deadline looming. However, we find the levels of disengagement demonstrated by these surveys worrying. Indeed, as we mentioned earlier, the FSA has already started to challenge firms on their planning for AIFMD, in the same way that they have begun to challenge firms on their planning around the Retail Distribution Review and how this will affect their distribution mechanisms.

Against that background, the EC's delay in implementing AIFMD should be taken as a welcome respite but not as an opportunity to further postpone engaging with it. There are sufficient details locked down now so that impact analyses and strategic planning can be started. While clearly refined drafting from Level 2 will be necessary for the fine tuning of responses, the overall thrust of AIFMD is clear. The directions taken by the Level 2 working groups are also providing some indicators to allow firms to make educated guesses about how AIFMD is likely to develop at a granular level. For example, it is likely to develop by drawing on the UCITS framework in a number of areas and also from the more advanced local EU frameworks for governing fund managers, e.g. Ireland, Luxembourg and the UK.

ITAS Survey – AIFMD Readiness



Plan in place – 2%
Dedicated working group in place – 16%
No preparations – 82%

What firms should be doing now

If firms have not already started carrying out impact analyses, now is the time to do them. These analyses can be combined with analyses on the impact of:

- the Solvency II regime for insurers on clients; this is forcing many insurers to require different information from their product providers (both in quality and quantity), as well as possibly providing products which will give them better outcomes under the new Solvency II capital regime;
- the US Dodd-Frank Act on non-US investment managers and advisers and the move to central counterparty clearing for derivatives;
- the new European Market Infrastructure Regulation, which will impose a new regime around the management and trading of derivatives; and
- the new regimes under UCITS IV and V (for alternative managers who also operate in the retail space).

These issues will fundamentally affect firms' strategic plans for structuring products and identifying markets and clients for those products going forward.

Strategic level reviews need to be coupled with operational reviews of internal processes. Understanding how to manage liquidity and knowing the detailed risk profile of funds under management will be critical. Firms should be working out whether their existing resources and techniques are adequate to define their own risks and prepare economic and operational risk maps of their own businesses in their fund models. It is quite possible they will determine that additional resource and new methodologies are needed.

Firms should also be working out now in detail how their internal structures and relationships with third party providers are going to function in the future. There is a major task ahead for those fund managers that have previously relied upon relationships with prime brokers and who have only used third party custodians as part of the asset protection plans which have emerged post Lehman. They will need to define relationships with depositaries, who will have significant regulatory responsibilities and charge accordingly, and redefine relationships with prime brokers who will want to remain "counterparties" and maintain 'business as usual' where possible.

While a great deal remains to be done to arrive at answers to the initial question which firms must be asking themselves – "how will AIFMD affect me?" – if major changes are found to be required or are viewed as desirable, then the implementation effort, time and costs required are likely to be substantial, so the two month extension should be regarded as no more than a welcome breather.

PwC's response

We are working with industry groups and national regulators on how the Level 2 responses should be shaped, as well as advising non-EU regulators on how to prepare for AIFMD.

Across all the alternative sectors, we are also working with a number of asset management clients to assess AIFMD's impact on their business models and strategic plans, on an integrated basis taking into account the other significant regulatory challenges they face.

In addition, we are assisting several service providers with AIFMD preparation, helping them create solutions for their asset manager client base, to diagnose the impact of AIFMD on their own businesses and operations and to ask the necessary questions to start formulating their long-term strategic plans.

If you have any questions on the directive and its impact on your business or how we might help, you should call your usual PwC contact or any of our experts named overleaf.

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 to your local PwC contact or one of our AIFMD specialists listed below:

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Annex: Timeline and Action Points