

A **Global Perspectives** White Paper



Global Perspectives

AIFMD – what you should be doing to comply

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Introduction

The AIFMD regulation comes into force in the 27 countries of the European Union in July 2013. The main tenets of this wide ranging legislation are now well known throughout the industry.

Put simply, AIFMD will change the alternative investment industry forever.

This is the first in a 2 part Global Perspectives white paper examining what fund managers should be doing right now to ensure they are ready for AIFMD. We will publish Part 2 of this white paper next month (June 2013).

Currently fund managers should be completing a detailed impact assessment to ensure they are ready for AIFMD. Global Perspectives (www.globalperspective.co.uk) can assist in completing your AIFMD impact assessment and implementing its requirements.

1. Identifying the AIFM

The very first AIFMD task an Alternative Investment Fund Manager (AIFM) must complete is to identify who the fund manager really is. The correct AIFM must be identified for each Alternative Investment Fund (AIF) in the investment group.

This is crucial because this AIFM will be the one legally responsible for ensuring the AIF is compliant with all AIFMD regulations.

Due to the complex structure of many asset management groups this identification process may not be straight forward. Nevertheless this

process must be completed urgently as so many of AIFMD numerous regulatory requirements stem from this.

AIFMD establishes a vague test for establishing the AIFM. The primary consideration is which entity carries out the funds' "investment management functions".

This is proving problematic for European "managed account" products.

2. Depository Selection

Under the AIFMD regulations **every** AIFM must appoint a "depository" to safeguard the investors in their funds. These will work like super-charged custodians who will closely monitor the assets in the fund, reconcile daily cash movements and provide independent verification that the fund is being run properly and the assets are where the manager says they are.

The depository will be wholly liable to the funds investors and is assuming a very wide responsibility of legal liability by taking on this role (they are on the hook even if the problem is in a sub-custody network outside of their control). Consequently only large companies with deep pockets will be able to offer this service (often tier 1 administrators who are part of global banks). One bankrupt fund could easily bring down a large bank. Depositories are expected

to charge handsomely for this mandatory service.

Right now managers need to be actively engaged in the depository selection process. Managers should have begun this selection process already, as it will take time and is an important investment decision.

Some depositories may not be willing to support an investment strategy weighted towards emerging markets or exotic securities. For managers the selection of a suitable, cost effective depository aligned to their investment strategy will be a key consideration.

For hedge fund and private equity managers the cost and intrusive nature of the new depository regime is a sea change in operational practise.

3. Authorisation

All European AIFM's must apply from authorisation from their home country regulators before July 22nd 2014 (i.e. one year after AIFMD becomes law throughout the European Union).

This approval process is not yet clear in key hedge fund jurisdictions like the UK (where over 80% of European hedge funds are based). The application for approval will likely require the fund manager to demonstrate full compliance with the 116 Articles of AIFMD.

Managers must be familiarising themselves with the full spectrum of AIFMD and how it will impact their business. This includes everything from depository requirements to remuneration rules, to leverage calculations and fund services delegation.

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The extensive scope of this analysis may require the engagement of specialist consulting expertise to assist in analysing the business impact of AIFMD.

Global Perspectives can provide full support in your AIFMD impact analysis.

4. Third Country provisions

AIFMD applies to any non-UCITS fund managed **or marketed** in the European Union. The rest of the world is slowly waking up to this.

Let us be clear – the non-European world will have to comply with AIFMD's requirements. The process for these "Third Countries" will be phased and gradual between now and 2018, but going forward if a non-European manager even wants to road show a hedge fund in Europe they will have to be fully AIFMD compliant.

Non-EU managers should be reviewing AIFMD to understand their initial requirements. They face a phased compliance period until the current regime expires in 2018. The initial rules require non-EU managers to provide "transparency reporting" with details of the fund, its investment strategy and its investments. This includes private equity funds. Further, more detailed, obligations will follow over the next 5 years.

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Non-compliance with AIFMD will mean being locked out of the world largest trading block.

The rest of the world should think of AIFMD like a European FATCA. i.e. non-Europeans are being given no choice but to fall into line and comply with AIFMD - just like the rest of the world had no choice but to comply with the US FATCA rules - whether they liked it or not.

5. Delegation and Due Diligence

AIFMD has new rules around what is required when a manager delegates some of its duties to a 3rd party. This obviously includes an investment adviser or fund administrator.

These rules make the manager directly responsible for the oversight of these parties. AIFMD requires substantial initial and on-going due diligence required on all service providers.

Service providers themselves are also now required now to complete extensive due diligence on their manager/client so managers need to be ready to accommodate these requests and meetings.

Managers should currently be engaged in this due diligence process for both new (e.g. depositories) and existing (e.g. fund administrators) fund service providers. Also it should be noted that AIFMD contained additional, more detailed rules regarding the delegations of portfolio or risk management functions outside the European Union. Managers need to be considering these additional requirements if they delegate these functions.

The cumbersome nature of these due diligence visits and checks may mean managers or service providers will want

to outsource this activity. Global Perspectives can provide you with full support for these due diligence requirements.

6. Remuneration policies

Some of AIFMD's most controversial new rules are around the area of hedge fund remuneration. They require fund manager remuneration policies to be disclosed to investors and regulators.

Remuneration must also be weighted towards long-term incentives. This means that employees must be paid at least half their bonus as shares in the fund. Furthermore they are not allowed to sell those shares for a minimum of 3 (and preferably 5) years.

AIFMs are also being asked to introduce prudent remuneration policies and organisation structures to avoid a conflict of interest or which may encourage excessive risk-taking. The implementation of the AIFM's remuneration policy must be reviewed at least annually.

Right now managers need to be reviewing their internal remuneration policies and taking steps to ensure it complies with AIFMD. In certain cases this will mean the establishment of a remuneration committee (if the managers total AUM is above €1.25 billion).

All of this represents a huge change for the remuneration

policies of most European hedge funds.

7. Leverage

AIFMD stipulates two brand new ways to calculate leverage. These are the "Gross" & "Commitment" methods.

The "Gross" method attempts to give a picture of the funds overall exposure. The "Commitment" method focuses more on the hedging and netting techniques used by the fund manager.

The key point here is that these are new, compulsory methods for leverage calculation. The more common "Value at Risk" (VAR) methodology is not acceptable.

Managers need to be working with their system vendors and internal departments to ensure these calculations are built into their software applications. They also need to be making initial leverage calculations using these new methodologies in preparation for AIFMD.

This is important because managers will have to report leverage to their home regulators and to investors. They will also have to monitor it closely and advise investors if they breach their stated leverage threshold.

8. Conclusion

The reward for complying with all of AIFMD's requirements will be an EU "Passport" to offer alternative investments across Europe, similar to that of the existing UCITS Passport. Over time this passport may become the new "gold standard" of alternative investment products and open up new

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global opportunities to the industry (e.g. in Asia and Latin America)

Part 2 of this white paper (released in June 2013) will address the other main AIFMD requirements that managers should be addressing. These will include:-

- Fund domiciliation,
- Fund manager liability,
- Investor and regulatory reporting,
- Liaising with Service Providers,
- Internal organisational change,
- Managing illiquid investments.
- Market opportunities presented by AIFMD

As can be seen from this white paper the demands of AIFMD are considerable. Global Perspectives (www.globalperspective.co.uk) can assist in completing your AIFMD impact assessment and implementing its requirements.

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