AIFMD

State of the Union

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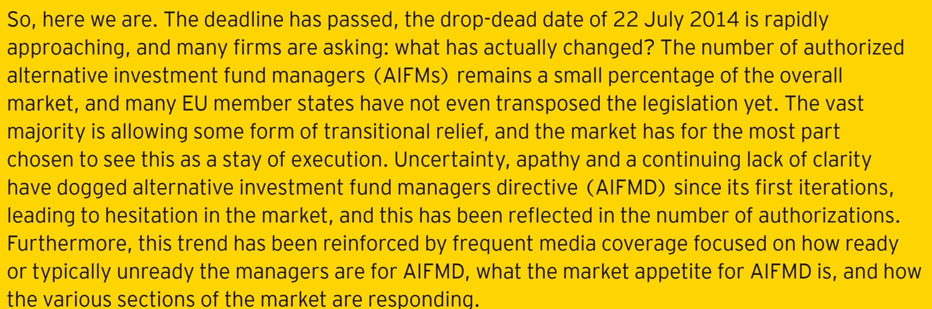
Building a better working world



So, here we are. The deadline has passed, the drop-dead date of 22 July 2014 is rapidly approaching, and many firms are asking: what has actually changed? The number of authorized alternative investment fund managers (AIFMs) remains a small percentage of the overall market, and many EU member states have not even transposed the legislation yet. The vast majority is allowing some form of transitional relief, and the market has for the most part chosen to see this as a stay of execution. Uncertainty, apathy and a continuing lack of clarity have dogged alternative investment fund managers directive (AIFMD) since its first iterations, leading to hesitation in the market, and this has been reflected in the number of authorizations. Furthermore, this trend has been reinforced by frequent media coverage focused on how ready or typically unready the managers are for AIFMD, what the market appetite for AIFMD is, and how the various sections of the market are responding.

While it is always useful to have a clear understanding of what your peers are doing, consistent benchmarking against the competition rather than against the opportunity could prove costly for many managers and doesn't allow for effective strategic planning.

In a recent survey, jointly undertaken with AIMA, EY sought to take a different approach and develop an understanding of EU member states' actual readiness to implement AIFMD in order to clarify the likely future operating environment for firms as they move toward authorization and beyond. The survey focused on transposition success rates, relief provisions, private placement and remuneration. The results were surprisingly positive.

Market readiness

The number of member states that have transposed — i.e., have the necessary legislation in place — is 15. In many ways this can be viewed as a success, given the continuing regulatory uncertainty and the varying implementation of previous EU directives. In recognition of this, Jiri Krol, AIMA's Deputy CEO and Head of Government Regulatory Affairs, was quoted as saying: "It rarely happens that all member states transpose on time but we are encouraged by the progress that is being made by some of the key asset management and fund jurisdictions in implementing the directive."

The majority of countries that are significant in terms of fund management or being alternative fund domiciles (the UK, France, Germany, Ireland, Luxembourg, the Netherlands) have successfully transposed the directive. Croatia is notable for having achieved transposition, given it only joined the EU 21 days before the implementation date; Greece, Portugal and Spain are still, perhaps not all that surprisingly, some way behind the transposition curve. The lack of transposition in Finland and Italy is more disappointing; particularly Italy, which has an active alternatives industry and is at the forefront of other areas of financial regulation.

But transposition does not necessarily translate to a full implementation of all of the supervisory and operational requirements associated with AIFMD. Instead, it means countries that have transposed are open for AIFM authorizations. It also means that AIFMs from transposed jurisdictions can start to utilize passports and organize their future product management and distribution strategies, whereas firms from countries that have not transposed cannot.

What is clear is that, according to ESMA, for EU AIFMs managing or marketing EU AIFs, a lack of regulator readiness should not be a barrier to market access. ESMA stated that, regardless of transposition status, a competent authority "may not refuse a valid notification made under Article 31" (i.e., a marketing passport notice) from an AIFM's regulator. The same principle has been applied in respect of the management passport.

Of the member states that have transposed or are close to transposing, 16 have taken the pragmatic approach and provided a transitional for domestic AIFMs, EEA and non-EEA AIFMs. Bulgaria has opted not to provide a transitional for any kind of AIFM, whereas non-EEA AIFMs will not benefit from any transitional relief in Croatia, Latvia and Malta. The availability of transitional relief should enable firms to continue marketing on an "as is" basis provided they comply with any preconditions imposed by local regulators.

Despite the attraction, firms should not use the transitional period as a sabbatical. With respect to registration and authorization, regulators have urged firms to start planning early. The CSSF and the FCA have been particularly vocal, with the latter stressing a "three-month and possibly a six-month turn around for complex applications," which effectively creates an application deadline of 22 January 2014 in the UK. Firms' applications that impinge the three-month timeline may find they are without an AIFMD authorization, come 22 July 2014.

A further emerging trend, both around the authorization process itself and in areas of the wider directive, is the increasingly competitive tension between member state regulators: they are also taking a lead from each other in terms of how pragmatic they feel they can be. The French regulator (AMF) has taken the approach that it already knows and authorizes a lot of firms in the market, particularly domestic AIFMs, and so will be as supportive as possible with them. This is reflected in the number of successful AIFM applications to date. In parallel, France is effectively gold plating the private placement legislation for non-EEA AIFs to such an extent that the market is effectively closed for private placement to open-ended funds. The question many people have is: what effect will this approach have on the decision-making process of fund managers when it comes to domicile and marketing.

Distribution and access

To date, one of the most contentious areas of the directive has been the National Private Placement Regimes (NPPR), and the extent to which AIFMD will provide or restrict distribution capability for funds and managers that have a touch point with, but are not registered in, the EU.

Currently, unregistered firms have to navigate a patchwork quilt of private placement regimes for cross-border distribution, and for certain marketing scenarios this is likely to continue because member states ultimately have discretion over market entry. On a positive note, EU managers marketing EU AIFs will, for the first time, benefit from the marketing passport.

The road ahead for non-EEA AIFs and non-EEA AIFMs will be complicated and, in some cases, not available at all. "So what's changed? – " a cynic might ask. To recap, AIFMD attaches four main conditions for private placement. In summary:

- Compliance with the reporting requirements
- Cooperation arrangements between member states and home country of AIFM and/or AIF
- AIFM and/or AIF must not be located in an FATF noncooperative country
- Appointment by EEA AIFMs to perform depo-lite services

If these requirements are not deemed sufficient, then individual countries can impose add-ons. In practice, it is the additional conditions that will make or break the accessibility of a particular market. The UK, Ireland, Luxembourg, Malta and Sweden are among a group of countries that have implemented the minimum conditions only. We wait with anticipation for the confirmation on private placement from Denmark and Italy. Latvia has explicitly stated it is not allowing private placement, however, for the majority of firms, this is unlikely to impact distribution strategy. France, Germany and the Netherlands, on the contrary have all imposed some form of additional gold plating to the private placement legislation.

France could be described as Latvia light. As previously mentioned, it is all but closed to the private placement of open-ended funds. In order to distribute open-ended AIFs in France, the AIF and AIFM will have to satisfy an additional equivalent supervision and authorization test, respectively. Open-ended funds are typically domiciled in offshore jurisdictions for two main reasons, and neither relate to robust supervision. Contrastingly, close-ended AIFs in France will only be subject to minimum conditions.

The picture is slightly more encouraging and arguably more balanced in Germany. EEA AIFMs will have to comply with the minimum conditions only, however non-EEA AIFMs will be required to appoint a depositary to perform the so-called depo-lite function. At the time of writing, we are still waiting for clarification from the Netherlands. Initial indications suggest that private placement will be less onerous than France but not as liberal as the UK.

So the patchwork quilt remains. But potentially not, under AIFMD; firms will face one of "three private placement options": closed, minimum conditions or minimum plus additional conditions, which should underpin distribution strategies going forward. Fundamentally, however, any non-authorized approach is effectively an interim solution as in 2018 ESMA is required to pass guidance on whether or not it would make sense to end NPPR. If it does so, the commission will have to pass secondary legislation phasing out NPPRs altogether.

Approach to remuneration

If private placement could be considered one of the most heated sources of debate around the directive, remuneration could be considered the number one topic on everyone's mind. First, not only because of the direct impact on firms' senior decision-makers' own pockets, but also because of the timely release of the FCA consultation paper detailing its approach to the remuneration legislation. In summary, the rules are clearer than many had dared to hope. The FCA can be commended on trying to remove as much ambiguity as possible for managers. They have provided very clear and useful examples, and fundamentally the key areas of proportionality, partnerships and share-based awards have all been given detailed consideration and reflect a much more collaborative industry approach. A particular positive to note is that the guidance has adopted the recommendation from EY and AIMA that a partner's profit share should be disaggregated into the effective underlying components such that only a portion of the profit share may be considered variable remuneration.

Industry readiness

In recent months, we have certainly seen a renewed focus from our clients on AIFMD. A combination of increased member state readiness, peer movements and impending deadlines has catalyzed many previously stalling AIFMD projects. Many of the senior managers who started their AIFMD programs more than a year ago are already well placed to meet the authorization deadlines. It would seem that many of the managers have now completed the critical decision-making process over who the AIFM will be and how the legal entities will be structured within their organizations. As a result, the focus is now shifting to ensuring that the AIFMs will pass the letter box entity test.

In the wider market, the focus of many managers to date has been on legal entity structuring, selecting a depositary and understanding the impact of the remuneration requirements. Now, we are beginning to see managers concentrate on how they will comply with the directive in practice. Operationally, meeting the ongoing reporting requirements to the regulator seems to be at the top of the agenda for the majority of firms. Relative to other areas of the directive, we were surprised at how little progress has been made in preparing for industrializing the reporting framework. This can be attributed, in part, to the lack of clarity from the regulators, who in turn are looking to ESMA for guidance and clarification: ESMA has made it clear that it is to take a prominent role here. We expect that their recent clarifications on reporting guidelines should act as a trigger event for many firms that have been holding off progressing their applications until the full scope of the reporting impact was clear.

The EY/AIMA survey highlighted that this is an area in which the lack of harmonization between the member states is most apparent. Where regulators have actually defined the requirements, there remains a variation in the reporting dates.

The reporting language is not consistent; it has been defined as either English or the official local language with the exception of the Netherlands, which appears set to require reporting in both.

Given the ambiguous context in which the managers have been working, it is not surprising that many firms are still struggling to assess how to respond. Once again the earlier adopters (particularly the larger houses) have conducted detailed analyses and in-depth requirements gathering on the basis of the ESMA templates and consultation papers, to assess whether they should build or buy the reporting capability. It is already clear that a large percentage of small- to mid-market players is likely to outsource to a third-party provider. But this creates a secondary problem — finding a suitable partner.

While managers are struggling to navigate the complex landscape of the reporting requirements, the readiness of potential providers to provide an effective solution has been a concern for a number of managers. Actual cost of the service is also an issue. Typically, we have noticed that where managers already have a Form PF provider, there has been more success in extending the service to include AIFMD reporting. However, the majority of the managers are left with a growing list of specialist reporting providers and a growing list of solutions from their administrators to choose from. EY has not only helped managers in the selection of the providers in this space, providing input on strengths, weaknesses, commercial models and benchmark pricing, but also has been involved in the development and validation of many of the solutions in the market.

Sheila Nicoll, who recently joined EY as a senior advisor in the asset management practice, and who was previously Director of Conduct Policy at the FSA, notes that "despite the complexities of the directive itself, and the difficulties in getting the necessary measures through both EU and national decision-making processes, the speed of progress in implementing the directive and allowing firms to take advantage of the benefits it is designed to bring is encouraging." There is still a lot to sort out but note the FCA, in particular, is seeking to be as sensitive to industry concerns as it can be, while fulfilling its obligations under the directive.

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