CAPITA

Asset Services

Post AIFMD – Is Europe worth it?

The introduction of the Alternative Investment Fund Managers Directive has brought with it many challenges for managers of non-EU alternative investment funds (AIFs) wishing to market their funds to EU investors.

Currently, and at the earliest until late summer 2015, non-EU AIFs can only be actively marketed within the EU using national private placement regimes (NPPRs).

National private placement regimes

Until at least 2018, non-EU managers of AIFs can market their funds to professional investors using the NPPR applicable to each individual member state. AIFMs subject to NPPRs are required to provide regular information/reporting to each relevant supervisory authority. These "transparency rules" comprise reporting in respect of annual reports, disclosure to investors and reporting to the relevant member state authorities where they market.

(i) Annual reports

The annual report must contain information that investors in AIFs would normally expect to receive, as well as detailed information regarding the manager's remuneration policies and practices, including the total amount of remuneration paid by the manager to its staff, split in to fixed and variable components. Additionally, the total remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF must be disclosed.

(ii) Investor disclosure

- Disclosure on cover for professional liability risks
- Details of any preferential treatment of investors, the type of investors who obtain such preferential treatment and their legal or economic links with the AIF or the manager
- The percentage of AIF assets which are subject to special arrangements due to their illiquid nature and details of such special arrangements
- Any changes to the maximum leverage that the manager may employ on behalf of the AIF, as well as any right to reuse collateral or any guarantee granted under the leveraging arrangement.

(iii) Reporting

Managers are also required to provide certain information on a regular basis to the relevant supervisory authority of each applicable member state. This reporting includes information about:

- The main instruments in which the AIF is trading
- The markets of which the AIF is a member or where it actively trades
- The diversification of the AIF's portfolio.

Frequency of reporting is dependent upon the amount and/or type of AIF related assets managed and may be quarterly, semi-annual or annual. The reporting covers a wide range of aspects of the fund requiring the consideration of circa 500 data points. It includes:

- Investment strategies
- Portfolio deconstruction at asset, instrument, strategy, geography and sector levels
- Markets traded
- Analysis of funding, borrowing and counterparty arrangements
- Derivative positions
- Types of investor
- Leverage
- Liquidity
- Stress testing
- Performance.

Passporting

It is envisaged that, at some time from late summer 2015 onwards, it will be possible for non-EU managers to be able to apply for authorization to market their AIFs under the passport system, subject to a positive decision to extend the passport to non-EU AIFMs by the European Securities and Markets Authority (ESMA).

Under this regime the manager to the AIF will be able to make an application to be authorized by the regulator in one member state, allowing the AIF to then be marketed across the entire European Union.

However, the reporting requirements outlined above, although restricted to the one regulator, remain the same.

Reverse solicitation

Given the onerous and complicated reporting requirements, many non-EU AIFMs have considered how else they can get access to European investors. Some are looking at, or are already using, "reverse solicitation", namely sales to investors who have, unsolicited by the AIFM or the AIF, approached the AIFM or the AIF requesting the purchase of shares/units.

The Directive's definition of marketing excludes such unsolicited approaches by investors (under Articles 36 and 42) so, in theory, these purchases are not subject to the rules of the AIFMD. However, the Directive does not provide any specific details on passive marketing and there is no guidance from ESMA either. What constitutes reverse solicitation varies from country to country and in many cases is based on market practice as opposed to written guidance. In fact, the initial drafts of AIFMD explicitly banned reverse solicitation and it was only following a sustained lobbying campaign by the hedge fund industry that concessions were made, largely due to a concern on behalf of the European Commission that a ban would be considered protectionist under international agreements.

This vagueness in the legislation means there are a number of things managers should think about before relying on this exclusion.

First, they should take care when employing a third party to market their products to European investors to make sure they do not breach the Directive's requirements.

Second, in a contentious situation, the burden of proof may be on the AIFM to show that it did not, in any way, solicit investors. Any communication, including websites, publications and roadshows, can be taken into account. Managers also need to be vigilant regarding data captured on their CRM systems or from website analytics. And what about casual conversations at conferences with individuals who subsequently turn out to be potential investors from Europe?

Finally, even in situations where the investor makes the first approach, the manager may still be caught outside the rules. While the UK regulator, the FCA, has explained that firms may generally rely on a confirmation from an investor that the approach is at his/her own initiative, they will take account of any evidence suggesting that marketing activity has been taking place.

The difficulties outlined above are further compounded by the fact that the regulations are subject to the local national laws which all differ in their interpretation of what constitutes reverse solicitation and the rules applicable to it.

The consequences for contravening the regulations may be severe. In the UK, which is generally regarded as one of the European countries with the most welcoming attitude to alternative investment managers, criminal law sanctions may be applied if marketing guidelines are contravened.

Importantly, investors have the right to recover, in full, any monies given as a result of unlawful marketing, as well as the ability to seek compensation for any loss sustained as a result of the investment.

Any manager following a "liberal" interpretation of reverse solicitation is taking a substantial risk; this should not be viewed as a strategy and is not a route that should be followed in the absence of local legal advice. Although it is not considered likely that regulators will pursue managers for minor transgressions, it would be difficult to ignore an investor accusing them of marketing without the proper licence, forcing the regulator(s) to consider taking enforcement action.

So is Europe worth it?

Given the difficulties outlined above, many managers have, understandably, been reconsidering their position on Europe. A recent Deutsche Bank Markets Prime Finance survey of 44 COOs of hedge fund managers (managing $325bn between them) found 90% are either undecided or uninterested in AIFMD compliance.

Nonetheless, this viewpoint may be short sighted as Europe remains an important investment market. Another recent Deutsche Bank survey, this time focused on the buy side, interviewed representatives from more than 400 investor entities globally and found that investors in Western Europe had the most interest in investing in alternatives, with almost 40% of them planning to increase their allocations during 2014.

Any manager looking to tap into Europe should recognize the conservative nature of institutional investors, such as pension funds and insurers, who make up the bulk of the institutional investment pool. They may not look kindly on managers who are perceived to be avoiding regulation. Indeed, many institutional investors now invest heavily, or even exclusively, in regulated funds and some will be looking for the safer option of AIFMD compliant funds.

Ultimately, a manager's response to the Directive must be a strategic one and will depend on a number of factors, including investor base, investor geography, investment strategy and risk profile. While some investors may seek AIFMD compliant products, others are happy with the status quo and their focus remains on the bottom line favoring a lower cost non-AIFMD solution.

CAPITA

Asset Services

Is there an easier way?

Non-EU managers may find using an independent AIFM, such as Capita, mitigates the regulatory and reporting headaches from both the NPPRs and, when applicable, the passporting regime, while at the same time avoiding the issues surrounding relying on reverse solicitation. The independent AIFM will take responsibility for AIFMD compliance, including:

- Maintenance of the required regulatory capital
- Monitoring of, and compliance with, the investment policy of the fund
- Putting in place a remuneration policy
- Liquidity management
- Risk management
- Regulatory reporting.

For managers wishing to avail of the EU passport, or for those with EU funds which will require a fully authorized AIFM to manage them from mid 2015, appointing an independent AIFM alleviates the continuous, onerous reporting requirements and provides managers with mind, management and resources on the ground without the added cost or complexity of developing an in-house solution. In addition, appointing an independent AIFM will not only allow managers to benefit from the third party provider's economies of scale but also from their network and relationships with other stakeholders, such as regulators, depositaries and administrators.

For managers who wish to continue to access the EU on a private placement basis we can help them to understand the market access and reporting requirements and help them comply with the substance provisions through our Jersey non-EU AIFM solution.

About us

We are part of Capita plc, a highly successful FTSE 100 plc with over $12bn in market capitalization. We are specialists, with many years of experience providing a full regulatory framework for funds, allowing investment managers to focus on their core strengths of fund distribution and portfolio management. We already work with over 50 investment management groups and more than 300 funds in this capacity, amounting to over $80bn AUM.

Capita is the UK's leading independent AIFM and currently provides services to around 50 funds across the UK and Ireland.

Our independent AIFM solutions are provided by Capita Financial Managers (Ireland) Limited and Capita Financial Managers (UK) Limited, which are regulated by the Central Bank of Ireland and the FCA respectively.

To find out more about our independent AIFM solution contact us:

Guy Dominy
Managing Director
t: +1 646 522 5123
e: guy.dominy@capitaifs.com

Or read our website **AIFM solutions**

FS14153b