



Distribution is a critical consideration for those wishing to market their hedge funds into Europe. But regardless of whether that fund is UCITS-compliant or an AIF, the continuous evolution of European regulation means that managers have to stay one step ahead, and evaluate just how much of an impact it will have on their marketing distribution strategies.

The following report will provide an assessment of current market regulation, how that is impacting the distribution of AIFs, and, importantly, what some of the key regulatory developments are in the pipeline that managers need to be aware of.

What's on? – Overview of current regulations

AIFMD

The Alternative Investment Fund Managers Directive ('AIFMD') was broadly transposed into national law across the European Union in July 2013, over which time asset managers have steadily adjusted to life under a regulatory regime; one which, unlike the UCITS regime, which is fund-based regulation, focuses on regulating the Alternative Investment Fund Manager ('AIFM').

"I would say that it has been 90 per cent implemented, meaning most EU asset managers are now fully compliant with AIFMD and availing of the funds passport to launch AIFs from various jurisdictions. We are seeing, in particular, quite a lot of UK AIFs being distributed into Continental Europe. The main issues that people originally had fears over have been covered and resolved; the dust has settled," comments Etienne Deniau, Global Head of Business Development, Asset Managers and Owners, Societe Generale Securities Services.

One of the biggest headaches that managers face today is regulatory reporting. Under AIFMD, this involves completing an Annex IV report, which contains over 300 separate data fields. Broadly equivalent to Form-PF reporting in the United States, the XML format delivery to national regulators proved challenging once AIFMs commenced reporting in 2014, but now, several cycles in, the regulators are receiving reports without issue.

"It has been a new opportunity for service providers because a lot of asset managers do not know how to produce Annex IV reports. The expertise of firms like SGSS means that we can provide an Annex IV reporting solution to asset managers," says Serge Balatre, Head of Business Development, Depository Services, thereby alleviating the pressure on in-house risk and compliance teams.

Shhh...don't mention the remuneration code

Aside from regulatory reporting, the biggest concern AIFMs have, particularly non-EU AIFMs using third party management companies in Europe, is the remuneration code under AIFMD; something that is also set to be introduced under UCITS V, which comes into effect on 18th March 2016.

"If you have an EU AIF or UCITS, whereby the portfolio management function is sub-delegated for example, to a US manager, indirectly the remuneration rules still apply to the US manager. And understandably they are not keen on this," explains Deniau.

Remuneration, in an AIFMD context, consists of all forms of benefit or payment paid by the AIFM to Code Staff in respect of services rendered. Code Staff include: senior management, risk management and anyone with a control function, such as heading up compliance, tax and accounting, legal affairs.

The remuneration component is bifurcated into two components: the fixed component and the variable component.

With respect to the variable component, between 40 and 60 per cent paid to Code Staff has to be deferred for three to five years. Fifty per cent of the variable component must be paid in units or shares of the fund (or equivalent ownership interest).

“It means that a part of the manager’s remuneration must be invested back into the fund itself. This is aimed at improving protection for the investor because they can see that the management company (AIFM) is paid with the instrument that they are selling. It creates a better alignment of interests. Also, the idea behind deferring the variable component (i.e. annual bonus) is to retain key staff within the management company,” says Balatre.

In addition, under UCITS V and AIFMD, if the performance of the fund is subdued, or makes a loss, then the remuneration applied to the management company shall be reduced.

UCITS V - Time for a refresh

UCITS V is the first sign of EU regulators attempting to harmonise the UCITS regime with AIFMD. When it comes into effect on 18th March 2016, UCITS V will provide even further protections to retail investors. The problem is that whilst Level I measures have been clarified, which broadly outline the scope of regulation, the industry is still waiting for clarification on Level II measures. These regulatory technical standards are yet to be approved by the European Parliament and Council, meaning that asset managers will have to appoint a depositary in compliance with UCITS V without knowing the contractual details of what that arrangement will entail.

“When Level II measures are approved, they will be published in the Journal of the European Commission and will then come into force six months afterwards. If the publication comes out 1st March 2016, for example, this means that the Level II measures will come into force on 1st September 2016. There is no doubt that currently the gap between Level I and Level II measure is creating uncertainty,” says Jean-Pierre Gomez, Head of Regulatory and Public Affairs for SGSS Luxembourg.

Depositary role under UCITS V versus AIFMD

The appointed depositary must be a CRD IV-authorized credit institution or other legal entity that can meet the minimal capital requirements or a national bank. The role of the depositary under UCITS V will cover the main tasks as apply to AIFMD – namely safekeeping of the AIF’s assets, cash management and general oversight – and as such most European depositaries should be well placed to carry out their duties under UCITS V.

However, UCITS V goes further. Whilst it has replicated the higher standard of protection under AIFMD, there are additional duties placed on the depositary. Principally, the depositary has to control the entire custody chain under UCITS V. There will be no exemption to the restitution of assets of a sub-custodian, which in some cases can apply under AIFMD.

“Under UCITS V the depositary has much wider responsibilities with respect to both the custody and the safekeeping of assets. This will require more control processes and legal expertise in non-EU countries where sub-custody arrangements apply,” states Balatre.

There will also be more stringent cash controlling and global asset restitution; meaning the depositary will need to do proper due diligence on the counterparty “to have full oversight of all counterparts to the UCITS fund and have a global view of the fund’s assets,” adds Deniau.

The assets of a UCITS will also need to be fully segregated and held in the custody account, which again goes further than AIFMD, where the depositary is responsible for the AIFs assets under custody but not responsible for the safekeeping of those assets.

“Before you had to segregate securities depending on the country. Now, you must have segregation of securities across the sub-custody network,” adds Deniau.

Under AIFMD, the depositary can relinquish responsibility of the AIF’s assets if it has third party custody arrangements in place, as chosen by the asset manager. Under this arrangement, it means that under the safekeeping rules the depositary is not responsible for the AIF’s assets, should anything go wrong. This is not an option for depositaries under UCITS V.

Also, with respect to the oversight function under UCITS V, if the asset manager or shareholder in the fund can prove that the depositary did not properly perform its oversight duties, the depositary will be on the hook for any losses incurred in the fund.

Independence between depositary and asset manager

Another important point under UCITS V is that there is independence of asset managers and depositaries within the same group. “Where a group act as both the depositary and also as asset manager within the same group, there must be a set of rules and Chinese walls between the two businesses. This is to guard against potential conflicts of interest,” states Balatre.

European Market Infrastructure Regulation (EMIR)

European Market Infrastructure Regulation (EMIR) is the European equivalent of Dodd-Frank and first went live in February 2014. This requires buy-side institutions and their bank counterparts to report derivative trade positions to a designated trade repository. In addition, fund managers are required to report mark-to-market valuations on all outstanding exposures to their counterparties, as well as report on all collateral that has been exchanged.

“EMIR is going live gradually. Right now, asset managers are required to report on the above but they are not yet fully required to clear with a central counterparty (CCP),” says Deniau. The first instruments scheduled to be cleared will be interest rate derivatives in June 2016. This will apply to clearing members, with financial counterparties subject to clearing obligations by December 2016.

The next key date is December 2016, when ESMA is scheduled to deliver its recommendations and guidelines on the Unique Trade Identifier and Unique Product Identifier, which fund managers will need for clearing derivatives with the appointed CCP.

Distribution - AIF and UCITS brand development

The AIF brand has a long way to go before it can ever be considered on a par with UCITS, which has had the best part of 30 years to build its reputation as the gold standard for investment funds among global investors. AIFs have only been able to avail of the AIFMD passport since July 2014.

As such, their track record is highly limited. But there are signs that the distribution potential of AIFs is on the rise. In Ireland, for example, assets in the Qualified Investor Alternative Investment Fund, or QIAIF, were up 21 per cent through November 2015 over a 12-month period.

Net inflows to QIAIFs were EUR31billion through November 2015, giving an overall aggregate total of EUR384billion.

The AIF brand...

Balatre believes that Europe wants to create a brand with the AIF just as it has done so successfully with UCITS; indeed, UCITS V regulation has just been translated into Chinese, representing a major distribution channel for asset managers in the coming years.

AIFMD needs to walk before it can run. The question is, with greater convergence between UCITS V and AIFMD, could Europe see the emergence of a single regulatory regime in the form of AIFMD II or UCITS VI? And if so, what impact could that have on the distribution and brand potential of AIFs?

‘Despite some of the differences regarding the role of the depositary, for example, the two regulations are roughly the same. Why continue with two regulatory regimes? One could argue that UCITS is designed for the retail investor and AIFs are designed for professional investors but if the regulation is well written I’m sure that one regulatory regime could suffice,’ posits Balatre.

Gomez does not think the AIF is yet a brand but could become one as AIFMD regulation has time to evolve.

‘That was certainly the case with the UCITS regime, which has gone through multiple iterations but with AIFMD, it is still in its first iteration. We haven’t seen a tremendous evolution under this directive. Why?’

‘The passport is given to the fund under UCITS. Under AIFMD, the passport is given to the fund manager. Therefore, if you have an AIFMD license, in theory you are allowed to sell your fund across the EU. A manager based in London or Paris, with a Luxembourg SIF, who wants to sell their fund to German investors, for example, will need to apply to BaFin, the German financial regulator, and await their approval,’ comments Gomez.

This is different to UCITS, where the manager can freely distribute his fund to German investors without requiring any approval from BaFin. ‘BaFin has the right, under AIFMD, to prevent the EU AIFM from passporting their Luxembourg AIF into Germany if they feel it is too different to a German AIF.’

‘That is a big difference, from a distribution perspective, between UCITS and AIFMD,’ adds Gomez.

The other distribution hurdle that the AIF brand must overcome is that it currently only seems to be available to professional investors, even though some people know about Non-UCITS retail schemes (NURS).

One of the main attractions of UCITS is that it can be distributed to all types of professional and non-professional investors. This is thanks to the strong regulation that UCITS funds must adhere to. AIFs, whilst attractive to hedge fund or private equity managers wishing to fully replicate their offshore strategy, do not have to offer daily liquidity and as such, this limits the scope of distribution.

‘Nearly 70 per cent of funds registered for distribution worldwide are Luxembourg-based funds,’ confirms Gomez. ‘When our clients want to sell an AIF to German investors – institutions or HNW individuals – it remains complicated. There are many questions from BaFin. Under AIFMD, managers can still use NPPR or reverse solicitation, so there are other distribution options available.’

Third country passport

One catalyst for increased distribution of AIFs in Europe will be the third country passport. ESMA has recommended Guernsey, Jersey and Switzerland, meaning AIFMs and AIFs operating out of those jurisdictions would be able to market freely across the EU, provided there were equivalent enforcement capabilities of the home regulator to ensure that the non-EU AIFM complied fully with the Directive.

The decision on when the passport will become enforceable in those three jurisdictions has been delayed, at least until the end of June, by when ESMA will have assessed a second wave of jurisdictions including: the United States, Singapore, Hong Kong, Japan, Cayman Islands, Bermuda, Australia, Canada and the Isle of Man.

“The rules are still yet to be clarified in many countries and the new regime that will apply to non-EU AIFMs is yet to be set up. We may expect some kind of a boom, and increase in fund activity under AIFMD, once ESMA establishes the rules of conduct but I’m not sure this will be feasible in 2016,” says Balatre. He adds: “If the third country passport is enacted next year, I think the number of AIFs being distributed across Europe will grow. When ESMA allows US managers to enter the European market and passport their funds it will enhance the AIF brand.”

The third country passport will increase the level of competition for European asset managers.

What’s next? – Regulatory clouds on the horizon

MiFID II

The most significant regulatory cloud on the horizon is MiFID II, which is set to radically enhance levels of transparency across the fund industry. Trading venues will be required to provide pre- and post-trade transparency and will need to implement invasive new systems and controls to comply with the transparency requirements.

Transparency reporting

On the reporting side, there is going to be a significant uptick in the amount of information required on order, trades and transactions. With respect to orders and trades, these will need to be reported in near real-time, with transactions reported on a T+1 basis. One industry commentator thinks that, on aggregate, it will amount to three times more data than that reported under MiFID I. The name of the individual or trading algorithm (particularly relevant to CTAs) responsible for the investment decision will have to be clearly identified.

As such, fund managers must start to make significant plans for how they will adjust to this new market structure environment and embrace even more transparency.

Product alignment

From a product perspective, MiFID II stipulates that the fund product sold or created must be in line with the investors’ needs. The aim is to provide even greater protection to investors.

“Will managers consider launching AIFs today if they have to consider whether the AIF is exactly adapted to the clients the manager is looking to target? Perhaps not. If I’m a fund manager, I’m going to seriously ask myself whether it makes sense, from a cost perspective, to launch a product today and then wait to find out if it complies with MiFID II. It will make the environment for AIF distribution very complicated, even though MiFID II has been delayed until January 2018,” opines Gomez.

AIFMD II? UCITS VI?

MiFID II could block any potential consideration of AIFMD II or UCITS VI.

Regarding UCITS VI, there is so much regulation in the market that if the European Commission were unable to give the new guidelines due care and consideration, it could potentially damage the UCITS brand; and that is the last thing they want.

UCITS VI is mainly focusing on the introduction of the depositary passport, like the management company passport under UCITS V and AIFMD.

“We don’t yet know whether there will be a complete redrafting of the UCITS VI directive or whether the EC will just make amendments. This remains a known unknown. Regarding AIFMD II, I think at some point it makes sense but so far, no news,” adds Gomez.

Priips

Priips is designed to enhance investor protection and one of the key tools to achieving this is the Key Information Document ('KID'). Like MiFID II, the fund sponsor will be beholden to present information in a clear, concise and straightforward manner "in good time" before there is a binding agreement. It will need to be published on the manager's website and as Alain Smeraldi, Global Head of Business Development at SGSS points out, the KID goes much further than the information required in the Key Investor Information Document under UCITS.

"Under UCITS the KIID includes a lot of detail on how much the manager earns, the price of the fund (TER) etc. However, Priips goes further. Regulators will want additional information from other market participants so as to show the price of liquidity, transaction costs and so on," confirms Smeraldi.

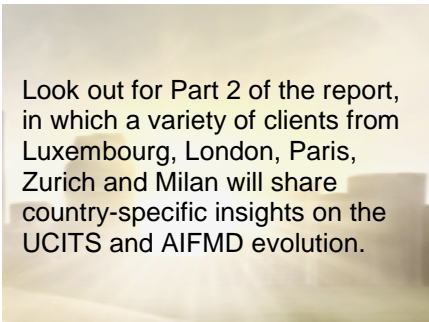
Priips will enter into force in December 2016 but UCITS funds that are already complying with the UCITS KIID have an explicit exemption until December 2019 to implement Priips obligations. The problem, however, as Alain Rocher, Head of Knowledge Management, Societe Generale Securities Services, points out, is that certain funds are the underlying investments of unit-linked insurance vehicles. "How can these insurance products give all the detailed information requested by Priips if the underlying UCITS are not ready to give them this information?"

"It seems necessary to align the obligations of both types of products so either there is no more exemption for these underlying funds either the exemption benefits both," says Rocher.

In conclusion, The European Fund and Asset Management Association (EFAMA) has called for a one-year delay to the Priips KID citing concerns over the "very limited time that product manufacturers will have between the final technical rules and the essential guidelines being published".

"Having provided extensive feedback throughout the ongoing level two work, we seriously doubt there will be enough time for market participants to implement the final rules by the end of this year," said EFAMA.

Under these regulatory conditions, there would appear to be a convergence between UCITS and AIFMD regulations, which in turn should make managers' compliance frameworks easier to implement. But from a pure branding point of view, AIFMD will likely need to go through one or two more iterations before AIFs start to resonate with professional investors.



Look out for Part 2 of the report, in which a variety of clients from Luxembourg, London, Paris, Zurich and Milan will share country-specific insights on the UCITS and AIFMD evolution.