Managers need to start performing a rational cost benefit analysis on the Alternative Investment Fund Managers Directive (AIFMD) and to strip out the emotion.

At least that's what Ernst & Young is proposing.

“The AIFMD knot is difficult. A single stroke of the knife won’t solve the problem as efficiently as a careful unravelling of the knot,” say Ernst & Young executives Samer Ojjeh, Principal in the Financial Services Office, New York and Kai Braun, Executive Director, Luxembourg.

“Unless managers decide to rely on reverse inquiries, their costs of marketing into Europe are going to increase. Firstly, the costs associated with building out the operational infrastructure. Secondly, the costs associated with increased service provider fees,” says Ojjeh.

Before examining those two cost areas in more detail, and where, potentially managers could curb them, it’s necessary to examine the four choices that non-EU - that is “Third Country” - managers face with respect to the directive, and which should form the basis of their cost benefit analysis.

**Reverse Solicitation:** Reverse solicitation is when managers stop marketing actively in a country and rely only on investor inquiry. Firms that intend to rely on reverse solicitation to market in the EU minimise AIFMD costs but ignore future possible EU revenues. This strategy may be appropriate for start-ups that are unable to bear the extra AIFMD reporting and compliance costs.

Reliance upon reverse solicitation may be appropriate for certain private equity funds. AIFMD and the National Private Placement Regimes (NPPRs) impose two additional burdens on private equity funds. One is the restriction on asset sale and the second is the requirement for disclosure of future plans to employees and regulators. These requirements may pose too big an operational burden on private equity by limiting flexibility.

Overall, the question must be answered as to how effective marketing will be via reverse solicitation. Firms must weigh reverse solicitation’s limits on marketing with the burdens of complying with the NPPRs or AIFMD.

Some managers are concerned with the level of compensation disclosures under the directive because it may result in the loss of clients or increased investor pressure to lower fees. Then again, firms should be mindful of the fact that most investors have that information if the firm is SEC-registered in Form ADV, from which they can make a reasonable guess at performance and incentive fees. Before using these disclosure concerns as a reason for abandoning the EU, it may be wise to talk with investors about how they might react to seeing such disclosures.

**NPPRs:** NPPRs are an intermediate step between doing nothing and doing everything. As such there are many benefits and also many costs that firms need to weigh carefully.

**Benefits:** NPPRs allow selective marketing in the EU without AIFMD’s heavy compliance burden. Firms avoid having restrictions on compensation, policies and procedures around risk and liquidity management, custodial obligations and securitised asset requirements. From a compliance standpoint, this is AIFMD “lite.”

**Costs:** NPPRs entail a heavy reporting burden, restrictions and considerable uncertainty. NPPRs require regulatory reporting as extensive as Form PF in every jurisdiction where a fund markets. Funds must file reports in possibly different...
formats and extend throughout the different jurisdictions, as well as frequently – quarterly depending upon the strategy and size. Finally, it is uncertain how long the NPPRs will last. Germany seems intent upon eliminating the NPPR system, and France, Italy, Spain and Sweden don’t allow it.

**Full AIFMD compliance:** Full AIFMD compliance is required for EU fund managers with EU funds. There are considerable compensation, tax and compliance issues involved in achieving this. In return, a manager gains considerable fund “passporting” advantages in the EU.

**Benefits:** AIFMD-compliant managers and funds enjoy unfettered marketing in the EU. A firm can market in all 27 EU countries while only reporting to one national regulator, giving AIFMD-compliant firms an advantage.

Initial AIFMD compliance offers first-mover advantages. Currently, there is considerable uncertainty around AIFMD’s actual implementation. Fund managers who engage EU regulators early may be able to shape AIFMD requirements in a specific EU member state that are favourable to a fund’s particular circumstances. Fund managers who wait will have to fight the precedent of early movers.

** Costs:** Full AIFMD compliance bears heavy costs. There are compensation and compliance restrictions. Custodians are responsible for safeguarding assets (even at prime brokers) and must monitor fund’s cash flows. Risk management, including liquidity risk assessment, and internal audit require separate functions. The result? AIFMD compliance will institutionalise most funds’ back office.

**Excluded Middles:** The world is not a series of absolute decisions. Decisions made in combination often result in the best alternative. While reliance upon reverse inquiry is probably insufficient in all 27 EU member states, it may be acceptable in certain countries to combine NPPRs with reverse inquiry.

**Benefits:** A combination of options will often address regulators’ concerns and allow funds to achieve marketing goals. A fund may use the NPPRs in certain jurisdictions and rely upon reverse inquiry in other jurisdictions. Done correctly, this allows flexibility to adapt to changing regulations and the fund’s evolution.

**Costs:** By waiting, a fund loses first-mover advantage. Amidst continued uncertainty, AIFMD’s first adopters will potentially influence regulators’ decisions. Sitting at the table and helping to influence decisions may bear considerable future dividends.

These are the choices available to Third Country managers. As to the potential costs involved, there are two key areas.

**Service Provider Fees:** “Because the AIFMD is mandating that the custodian is responsible for safeguarding and monitoring the assets that are held at a PB, clearly that’s a risk that the custodian is taking on. That cost will be passed, one way or another, to the manager or the fund, so they will start seeing some level of fee increase for the risks that the custodians are forced to take under the directive,” explains Ojjeh.

The extent to which custodians monitor their clients’ books will also impact on cost, i.e., if they are required to “shadow” the book on a daily basis, it will result in higher costs than if they perform this function on a monthly basis. Alternatively, custodians could rely on certain data of the administrator, but this would require initial and ongoing due diligence.

The enhanced requirements could also lead to custodians having to improve their systems to effectively monitor what could be highly complex strategies such as private equity, distressed debt and banks loans.

“That’s correct. It’s something that the custodian will now have to do in addition to the fund administrator, even though most of the managers’ costs are already associated with the fund administrator performing this function. Will the costs of being AIFMD-compliant outweigh the benefits? That’s what managers will need to consider with respect to these additional service provider fees,” says Braun.

**Operational infrastructure costs:** Infrastructure build-out will likely be the bigger expense for managers. Ojeh draws a parallel to the expenses incurred under Form PF. He notes that managers are undertaking an equivalent level of spending to comply with reporting requirements either under the AIFMD as a fully compliant manager or under private placement rules.

“They will need to have the infrastructure
Ernst & Young infrastructure and governance capability in place. We’ve seen managers who have done so reap the benefits because they are focusing less on manual processing and more on leveraging the data across various regulations. Take Form PF and AIFMD: there’s sufficient data overlap. Unless the manager has the capability to automate the production of Form PF, they will have to re-do the task multiple times to comply with the directive,” adds Braun.

“Developing a level of automation and establishing governance controls to ensure that the data is clean, effectively managed: that’s really a great way for managers to comply with the directive and better manage the costs of regulation at large.”

Market rationalisation will be the likely outcome as managers perform cost benefit analysis and gain a clearer understanding of the economic merits, or lack thereof, of continuing with private placement in the EU. “We are already starting to see that,” confirms Ojjeh. “Managers are saying that if they need to rely on private placement rules, they’re going to look at certain markets where there are not substantial capital-raising opportunities, decide to exit those markets and rely instead on reverse solicitation inquiries. Also, if certain jurisdictions decide to add more reporting rules once the directive is up and running, it could further accelerate that rationalisation process.”

Conclusion

The key theme here is that for Third Country managers a holistic appraisal needs to take place to establish the cost benefits of Europe from a fund-raising perspective. That analysis should be enterprise-wide and incorporate not only regulatory compliance, but also risk management, operations, technology, marketing and investor relations.

“There’s no absolute answer. There are different scenarios to consider. It’s a complex issue that needs to be done methodically. And the problem is, the clock is ticking. Managers need to figure out quickly how they intend to navigate these waters,” concludes Ojjeh. ■

The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or Ernst & Young Luxembourg.