In An American in Paris, Gene Kelly spends considerable time adjusting to the new, strange Parisian landscape.

Like Gene Kelly, US investment advisors operating in the EU must learn to navigate an unfamiliar European environment. The Alternative Investment Fund Managers Directive (AIFMD), which collectively consists of a directive, a regulation and guidelines, took effect on 22 July 2013. The AIFMD may impose greater reporting and compliance burdens on investment managers than the US Securities and Exchange Commission (SEC) rules. Many American investment advisors are struggling to dance to this newest European tune.
The AIFMD collectively refers to a set of releases that comprise an EU directive issued on 8 June 2011, an EU regulation issued on 19 December 2012, and additional guidelines from the European Securities and Markets Authority (ESMA). The directive outlines the EU’s philosophy toward alternative investment fund management, whereas the regulation contains the methods intended to implement the directive’s philosophy. ESMA will publish guidelines to establish consistent and effective supervisory practices around the AIFMD. On 11 February 2013, ESMA published its guidelines for implementing sound AIFMD remuneration policies, and on 1 October 2013, ESMA published the guidelines on regulatory reporting. In addition, each EU country (Member State) has, or is still creating, country-specific requirements based on the country’s interpretation of the AIFMD. Investment managers need to analyze all these documents together since important operating rules are often in separate documents. Together, however, they form the EU’s rules of investment management, similar to the US Investment Advisers Act of 1940.

American investment managers falling within the AIFMD’s scope can comply in one of the three ways: they can establish an EU manager and EU fund for full AIFMD compliance, they can rely on the national private placement regime (NPPR), or on reverse solicitation thus, abandoning EU marketing efforts. The choices have different implications for a manager’s fund-raising, compliance, reporting, compensation and tax structures. Managers must resist temptations to heed George Washington’s advice to avoid foreign entanglements; instead, they must carefully consider the best of some potentially challenging options.

In order to make realistic comparisons among the three choices, it is important to understand each choice’s requirements and impacts.
**Full AIFMD compliance**

Many US managers already have fully functioning offices in the EU and are soliciting clients and managing money with all the necessary infrastructures. They do not have an option but to comply fully. The AIFMD contains compensation policies that firms must follow. Firms will need enhanced risk and liquidity management policies, as well as regulatory reporting similar to Form PF. Investor disclosures must be enhanced, including disclosing compensation and risk and liquidity management processes. Fund and personnel relocations have tax implications. If done successfully, investment managers can limit the AIFMD’s effects and enjoy marketing their funds to professional investors in the EU. The following diagram illustrates the AIFMD’s pervasive impacts on all aspects of a fund and fund manager. The AIFMD affects compensation, capital, conduct, fund governance and reporting in profound ways.
Marketing
Full AIFMD compliance gives a manager and their funds the benefits of the European passport and access to all EU professional investors. This covers most large financial institutions; it does not include family offices and wealthy individuals, except under certain circumstances.

Remuneration
The AIFMD has compensation squarely in its sights. The AIFMD requires that investment managers have compensation committees when the firm’s size warrants it. The AIFMD requires, subject to fund size and other exceptions, that 50% of incentive compensation be reinvested in funds and that 40% to 60% of incentive compensation be locked up for three to five years unless the life cycle of the fund is shorter. These requirements also extend to any manager to whom the fund delegates portfolio or risk management. While many firms have already voluntarily taken steps in this direction, it will now become a regulatory requirement.

Risk management
The AIFMD requires an autonomous risk management function. Funds must adopt risk limits, specifically regarding leverage. Managers must monitor their funds’ risk limits, report any risk limit breaches to investors, and monitor whether risk measurement and reporting adequately manage the portfolio’s risk. Risk managers must report directly to the management committee, and their compensation must be independent of the portfolio’s performance.

Disclosure
The AIFMD dictates investor and regulatory disclosure. The most onerous investor disclosure addresses compensation issues. Regulatory disclosure is similar to US Form PF disclosure but different enough to be vexing.

The major change in investor disclosure is the requirement to disclose remuneration in funds’ annual reports. The compensation disclosure must include a breakout of fixed and variable components for the fund manager and the funds marketed in the EU. Managers must disclose in their funds’ financial reports, the staff’s compensation, broken down into fixed and variable components paid by the manager. For each fund, the manager must disclose aggregate compensation of the fund manager’s senior staff whose actions have a material impact on the fund’s risk profile. Although these disclosures are aggregate rather than individual, additional information must still be gathered and verified.

Private equity funds must manage additional restrictions and disclosures. Private equity fund managers must not asset-strip any EU-based private companies that they invest in for a period of 24 months after acquiring control. In addition, private equity fund managers must make frequent disclosures to regulators and the
employees of the EU companies they own. AIFMD compliance may be difficult for private equity funds.

The AIFMD requires disclosure to investors prior to their initial investments. Investment managers and funds must disclose:

- Investment strategy, including leverage and trading limits
- How the fund would change investment strategies
- The nature of the fund’s contractual agreements with the investment manager, prime brokers, custodians and counterparties
- Key fund service providers
- The source of the investment manager’s capital or insurance to cover professional liability
- Delegated investment management or depository functions
- Valuation procedures
- Liquidity management procedures
- Fees and expenses
- Preferential investor treatment
- Latest annual report
- Procedures for selling shares
- Latest NAV
- Performance
- Prime brokers and any conflicts between the prime broker and the custodian
- Methods for distributing periodic investor information

Most investment managers will use a supplement to their existing offering documents to disclose the required AIFMD information.

Regulatory reporting is a major hurdle. Detailed reporting requirements apply when a manager’s assets under management exceed €100 million for levered funds with regular withdrawal rights, with total assets counted using derivatives at notional amounts. The data need is intense; although the AIFMD form is similar to Form PF, it is different enough to be challenging, especially regarding leverage calculations, liquidity stress tests and the calculation of total assets when notional amounts of financial derivatives are calculated using the price of the cheapest-to-deliver securities instead of 10-year equivalents. Timing is a major concern since the AIFMD’s regulatory reporting is due one month after the end of the relevant reporting period. With firms and administrators struggling to meet a 60-day Form PF deadline, the AIFMD presents a higher hurdle to a stumbling runner.

- **Custodians**: full AIFMD compliance requires unprecedented cooperation among managers, prime brokers and custodians. AIFMD funds must have a custodian. The custodian must guarantee the existence of certain financial assets, even if third-party entities, such as prime brokers, hold them. Finally, the AIFMD requires the custodian to monitor the fund’s cash flows, position breaks and risk limits on a daily basis.

- **Asset-backed securities**: the AIFMD imposes additional burdens on fund managers who invest in asset-backed securities. Managers must monitor originators’ investments in their own transactions. Fund managers must be able to track the underlying collateral’s performance and perform stress tests on structures and collateral. Distressed investing will be considerably more complicated.

- **Delegation**: the AIFMD attempts to settle the question of how many activities an investment manager can delegate to another entity before the investment manager becomes a “letter-box” entity. The AIFMD defines the two key areas of investment management as portfolio management and risk management. The AIFMD allows investment managers to delegate one of these functions as long as the entity performing one is not considered a “letter box.”

- **Other considerations**: additionally, the AIFMD addresses a broad range of fund governance issues, such as conflicts of interest, best execution, insider trading, required insurance and equity for fund managers. While most SEC-registered firms will be able to substantially comply with the AIFMD’s requirements, fund managers should examine existing policies and procedures to align them with the AIFMD’s requirements. The AIFMD may be thought of as the Investment Advisers Act on steroids.

- **Implementation**: for existing EU managers, AIFMD compliance is required starting in 2014. Existing EU funds and managers have a transition period of one year to register and comply. During the interim period, the European Commission wants managers to use “best efforts” to comply with the AIFMD. After 22 July 2013, new EU funds or managers will need to comply with the AIFMD.
National private placement regimes (NPPRs)

This choice replaces a compliance burden with a reporting burden. Non-AIFMD-compliant firms can continue to sell their funds in the EU, provided they report to each national financial security regulator in each country in which the funds market. Funds and, more important, fund managers do not have to comply with the AIFMD concerning compensation, risk management and other requirements, except for certain reporting requirements. Funds and fund managers can replace the AIFMD’s compliance yoke with the burden of reporting to as many as 27 different regulators.

Marketing restrictions
Initially the AIFMD should open up countries like Spain that currently do not have an NPPR. Unfortunately, many countries with existing NPPRs may move to force full AIFMD compliance by making their NPPRs increasingly burdensome. The general sentiment is that countries will make the NPPR more restrictive and burdensome over time, thus forcing AIFMD compliance.

The following map illustrates the current status of the private placement regimes by individual states. Many jurisdictions adopted their private placement regimes with individual twists. Ireland requires that all funds be registered as qualifying investor alternative investment funds. France requires prior approval before a manager can market a fund. New funds in Germany must obtain approval and have a custodian in place. Managers should consult local counsel before beginning to market in a particular country.

Disclosure
The AIFMD imposes reporting requirements on funds and fund managers that rely upon the NPPRs. They include the compensation disclosures in annual reports to investors. Funds and investment managers must report in all jurisdictions that permit private placement marketing. There is an AIFMD reporting template that provides the minimum data requirements to report on; however, each country’s regulatory authority is free to alter the template to suit its individual needs. The timeline for reports to regulators is one month after the end of the relevant financial period.

Custodian
Certain countries, such as Germany, might require a custodian under the national private placement regime to safeguard assets. Until the individual country’s regulations are established, the specific custodian requirements are unclear.

Timing
There is considerable uncertainty about the implementation of NPPR registration and reporting. ESMA’s original reporting date was 31 January 2014. In its final paper, ESMA adopted a principle-based approach that relied upon the transitional provisions of Article 61(1) of the AIFMD, the European Commission’s interpretation of Article 61(1) as set out in its Q&A, and the fund manager’s authorization status. From this it appears that the most likely initial reporting date will be 31 January 2015, which is one month after the end of the first full quarter after the end of the 22 July 2014 transition period.
Reverse solicitation

This choice removes any AIFMD compliance burden in exchange for ceasing marketing in the EU. Non-AIFMD-compliant firms can accept investors only if the initial inquiry comes from the investor and is not part of communications initiated by the manager. The EU is thought to enforce a high standard on reverse solicitation. Managers who want to rely upon reverse solicitation will want to adopt careful policies and procedures centered on marketing and client communications in order to comply.

Marketing restrictions
Reverse solicitation requires ceasing all marketing in the EU. Marketing will be defined differently by each country. Managers should take care that the actions of all their client-interfacing employees do not inadvertently constitute marketing and make the reverse-solicitation option unavailable. Managers must also prepare to justify the client's choice of reverse solicitation in the event of examination or regulatory inquiry. This will require stringent procedures and controls.

Compliance
Proving that reverse solicitation has occurred will place a large burden on a fund's compliance procedures. Managers must document that investors' inquiries arose without previous contacts. Websites should be restricted. Consulting relationships and capital introductions need scrutiny. Quarterly updates should be reviewed to avoid marketing, and client meetings should be scrutinized. Policing reverse inquiry may be more expensive than selective registration.

Considerations
The following table illustrates the trade-offs involved in the choice of complying fully with AIFMD, continuing under the NPPR or relying upon reverse solicitation.

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<th>Choice</th>
<th>Pros</th>
<th>Cons</th>
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<tr>
<td>Full AIFMD compliance</td>
<td>Access to entire EU for marketing</td>
<td>Compensation rules</td>
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<tr>
<td></td>
<td>Single regulator, single reports</td>
<td>Additional compliance</td>
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<tr>
<td>NPPR</td>
<td>No compensation rules</td>
<td>Multiple regulators and reporting</td>
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<td></td>
<td>No additional compliance</td>
<td>Increased uncertainty</td>
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<tr>
<td>Reverse solicitation</td>
<td>Minimal compliance</td>
<td>No EU marketing effort</td>
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<td>Proving no solicitation</td>
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Managers who want to rely upon reverse solicitation will want to adopt careful policies and procedures centered on marketing and client communications in order to comply.
There are no easy choices. Full AIFMD compliance offers reporting simplification and regulatory certainty. Under the AIFMD, investment managers must weigh the costs of compensation restrictions with their impact on retaining personnel, and they must consider increased compliance versus the benefits of unfettered marketing in the EU. The NPPR avoids expanded, burdensome compliance but presents a reporting nightmare and uncertainty. Under the NPPR, investment managers must balance multi-country reporting and regulatory uncertainty without any compensation restrictions or additional compliance burdens. Relying upon reverse solicitation restricts fund-raising and raises the bar to demonstrate compliance. Investment managers must weigh these options carefully.
Our suggested approach

We suggest a five-step AIFMD approach. First, investment managers should compare their requirements with AIFMD possibilities. Second, firms should construct a cost-benefit analysis that compares the benefits of possible alternatives with their associated costs. The third step is to choose an alternative. The fourth step is to plan for implementation by developing a gap analysis between the current state and future needs. The fifth step is the actual implementation. Any alternative requires work centered on compliance and reporting.

Step one: impact assessment
Managers should assess the AIFMD’s potential impact. This requires identifying the status of the current EU investor base as well as marketing plans. A firm with aggressive EU marketing plans will have different AIFMD requirements than a firm willing to confine its marketing activities to a select group of countries and funds. Should managers wait and see how the AIFMD develops or jump in now and enjoy first-mover advantages? Only by marrying their firms’ strategies with the AIFMD’s requirements can they begin to develop viable solutions.

Steps two and three: strategy definition and selection
Fund managers should vet each viable AIFMD solution in a consistent manner. A cost-benefit analysis allows them to compare one alternative against another and weigh the pros and cons of each. This should help contain debates over such emotional subjects as compensation and additional expenses. A consistent approach should forge a strong consensus.

Step four: detailed planning
This step results in an orderly implementation road map. Any potential AIFMD solution, even a total EU abandonment, will require redeployment of resources. A gap analysis will identify the differences between current resources and future requirements. The gap analysis also provides a basis for a tactical plan to make changes in an orderly and timely fashion. The final step is a detailed plan and timeline for AIFMD compliance.

Step five: implementation
This step realizes the efforts of the first four steps. The firm gives individuals resources, tasks and timelines. Progress is monitored, and unexpected consequences are addressed. If firms have spent time carefully considering their options and planning the transition, this generally results in efficient execution.

A studious AIFMD approach will bear major benefits. The AIFMD makes Form PF look like a model of clarity. Careful thought and planning can overcome uncertain regulations and identify opportunities where only obstacles were thought to exist.
Summary

The AIFMD will transform US managers' European operations. Some managers will withdraw. Some managers will become fully AIFMD-compliant and enjoy relatively unfettered marketing opportunities. Most managers will probably endure the NPPR with additional regulatory reporting and uncertainty until they can no longer bear the torment or the NPPR terminates. No matter which path a manager chooses, it is important to understand that the AIFMD will have a profound effect on the manner in which a firm does business and on its future, not only in the EU but also in the US.

As US investment managers begin to dance to the AIFMD's music, fund managers should keep the following suggestions in mind:

1. **The devil is in the details.** The AIFMD is quite confusing, with important points in seemingly random parts of the document. The directive contains the provision that remuneration should be split into variable and fixed components. The regulation specifies how to disclose remuneration, and the 2013 ESMA guidelines specify that the guidelines also apply to other firms to which the investment manager delegates risk or portfolio management. AIFMD compliance requires careful scrutiny of numerous documents.

2. **This is the step two of torment.** The EU is not private-fund friendly. Operating under either full AIFMD compliance or the NPPR will be difficult since regulators are testing new regulatory powers on a new industry. One merely has to observe the U.S. Commodities and Futures Trade Commission’s efforts to coordinate swap regulation and to project that onto 27 different countries to appreciate the magnitude of the problem.

3. **Don't let the AIFMD be the straw that breaks the camel's back.** The AIFMD, Form PF and Form CPO-PQR individually pose tremendous burdens on operating, accounting and legal staff. The combination of all can be traumatic, especially given the AIFMD’s one-month reporting requirements and its one-size-fits-all reporting.

4. **Do not confuse a project and a process.** Managers should recognize that reporting to investors and regulators is not a project. Reporting is a process that must be efficient and consistent.

5. **This is the time for adult supervision.** The AIFMD presents many critical decisions. What is the firm’s future in the EU? How should the reporting elements be managed? The AIFMD also touches on many emotional issues, such as salary and internal-support spend. Calm, cool heads should explore the pros and cons of various alternatives in a manner free from knee-jerk, sound-bite reactions. A thoughtful, careful process that removes emotion will generate the best results.

6. **Talk to the regulators.** The EU is not a monolith. Some regulators and jurisdictions are private-fund friendly and may be inclined to interpret AIMFD uncertainties favorably. As part of the exploratory stages, managers should meet with regulators to discuss their thoughts.

7. **Don't forget the tax man.** AIFMD compliance requires relocation of funds and personnel into the EU. These choices have tax implications. Make sure to consult a tax expert before making decisions.

8. **Choose dance partners carefully.** The AIFMD touches the sensitive areas of compliance, compensation, reporting, tax and firm infrastructure. Managers need experienced partners with expertise and knowledge in all these areas. Do not be penny-wise and pound-foolish.

9. **In adversity there is opportunity.** Many managers will withdraw from active marketing in the EU and most certainly in particular EU countries. This may create an opportunity for AIFMD-compliant managers to seek investments in a less-competitive pool. In addition, the AIFMD may become the standard for European pension funds and insurance companies. This will dictate some measure of compliance for funds with those investors.
With the AIFMD, the EU is playing a new tune for investment managers in Europe. Just as Gene Kelly adapted in *An American in Paris*, US investment managers must understand the new tune and adapt quickly to the new environment. If managers adapt successfully, the AIFMD may present opportunities for success. If US managers ignore the AIFMD, they may be too far behind in Europe to ever catch up. With hard work and planning, American managers in AIFMD land can, like Gene Kelly in Paris, enjoy success.
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