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Chapter 2

Allowing AIFMs to Decide How to Address New Market Challenges

Fieldfisher LLP

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This year, in the third year of this publication, this keynote chapter will be slightly different from that for previous years. AIFMD regulation has now settled down. Thankfully, it is time to move on to discuss how we make regulation work better, what the future should be for regulatory developments – and, perhaps most importantly, leaving regulation aside, how product offerings should develop.

Investment fund products should obviously evolve having regard to the relevant regulation – in particular within Europe, having regard to how the UCITS/AIF divide might evolve, and whether some specific types of fund vehicle will help meet particular challenges in the market place. We discuss below three particular areas which are being considered in the context of the future for AIFMD regulation.

A key question though is whether the key challenges for those operating in the alternative investment fund arena should be decided more by the fund managers, than driven by the terms of their regulation.

The new certainties

Whether one agrees with all of its contents, one positive point in relation to AIFMD regulation is that at least we now have relative certainty as to the shape of it. Before looking at the future for AIFMD regulation, it is worth considering whether it has settled down in the right direction.

Oddly, it is often easy to forget the point of regulation! The central purpose of regulation, in whatever sector, is generally to secure that those who are regulated follow best practice. It should not be, we would submit, to push product providers into providing a product in a certain way or to change the product. As the AIFMD implementation phase has worked through, there have been some clear challenges for regulators seeking to ensure that AIFMD regulation secures best practice from alternative investment fund managers and yet does not do so to such a prescriptive degree that it either constrains AIFMs from doing what they wish to do, or go so far as to stop AIFMs offering the relevant AIF product which they ideally wish to set up.

There is always a risk, particularly with some politically driven initiative such as AIFMD, that new regulation drives behaviours which are not ideal, or workarounds for difficult provisions are found which do not best secure the regulator's intentions. Any new regulation can create unwelcome uncertainties – and AIFMD more than most.

To name just three specific – and possibly unintended – consequences from implementation of AIFMD, arising for a variety of alternative investment fund structures:

- **Depositary appointments**

  A key protection required under AIFMD is that a depositary is to be appointed for an AIF. The severe liability provisions applying to a depositary, and the extent of its role, taken together with the limited range of types of firms which can provide the depositary service, may be adding unduly to costs of AIF vehicles – and costs of course are usually eventually passed on to investors.

  The range of depositary service providers has increased so competition between depositary service providers may increase over time, but arguably there is more work to do in this area. Are there excessive barriers to entry for depositaries?

  We can think of several examples where, for interesting portfolio management products, the answer has been that few, if any, depositaries will offer their services for certain structures which might potentially have been AIFs, and the answer has been to restructure them so that they fall outside of the AIF definition.

- **Valuation arrangements**

  The valuation provisions offer a good example where the liability and cost issues have driven a particular response to AIFMD. Unlike the depositary appointment scenario, there is a choice in relation to responsibility for valuation.

  The consequence of the valuer liability provision in particular has driven most AIFMs to structure arrangements, or restructure arrangements, so that the AIFM assumes responsibility for valuation. Most firms providing the valuation function have refused to accept the appointment as an external valuer, even when an external valuer would be the more logical position.

  Ironically, if the regulation had not been so severe, we may have reached the more logical position – whereby the valuer would have accepted the external valuer appointment, and arguably provided independence on this topic – and so greater protection within the fund governance arrangements.

- **Compliance costs, and reporting**

  For AIFMs, the onerous requirements for compliance with AIFMD have presented their own challenges. One major headache is the reporting obligations under AIFMD.

  It should be noted that these are in fact more onerous than in respect of UCITS. The UK FCA have indicated that it would like streamlined and developed reporting for UCITS in order to identify the possible build up of systemic risk, even in the UCITS sector, in certain areas such as portfolio liquidity and use of leverage (especially when based on VaR measures) where there are potential systemic concerns.

  Moves to try and streamline reporting requirements would no doubt be welcomed by fund managers. Taking into account AIFMD concerns, together with other initiatives involving reporting (notably EMIR and prospectively under MiFID II), investment managers face a major challenge in co-ordinating provision of reporting – and indeed, for regulators, how to receive and analyse and interpret data reported.

This particular issue does not as such drive workaround solutions – but it does provide one illustration of the costs of compliance with AIFMD and other new regulation which might deter fund managers from launching new AIF products. It can act as a barrier to establishment of new AIFMs and prevent existing AIFMs widening out their product range. Indeed some service provider AIFM offerings are restricting themselves to remain sub-threshold themselves. Trying, where appropriate, to streamline and make AIFMD regulation more practical might encourage new entrants and new products.

Set against these (and other) potential negative issues, though, at least we now have a relatively certain way forward. Generally, we know the shape of AIFMD regulation, and the value of some certainty of applicable regulation should not be underestimated.

With some degree of certainty now achieved, fund managers have a clearer set of choices when devising a new product. There is a clear decision as to whether to provide an EU AIF with an EU AIFM and many are now choosing that route, albeit with the consequent additional regulatory costs that this involves.

Also it is certainly welcome that the EU Commission now takes the approach that it should let existing regulation settle down.

The future for AIFMD regulation

There has been what seems like a relentless pace of new regulation affecting asset managers recently. Now seems a good time to focus more on improving existing regulation.

The current undertaking by the EU Commission to consider the future direction of financial services regulation, and how the financial services industry can best serve consumers and businesses, should hopefully remove some of the unintended consequences, inconsistencies and regulatory barriers.

To set out three key areas where, in relation to AIFMD, there is further work to do:

- **Should we look for logic?**

  A problem is emerging with the logic for regulation of EU investment funds.

  To some extent, this was inevitable. The EU Commission had the product-specific UCITS Directive – which is for a UCITS product which is designed to be suitable for those in the retail sector. It then introduced AIFMD regulating managers of all other funds (rather than alternative investment fund products) designed to be suitable for professional investors. The differing approaches of these two Directives inevitably gives rise to some awkward areas.

  Even taking the basic premise that UCITS are for retail funds and AIFs are for professional investors, already we have several exceptions to prove this rule:

  - ELTIFs are AIFs but with a retail passport;
  - there is much UCITS product which is sold to institutional investors;
  - structured UCITS are to be deemed complex products for MiFID II purposes, alongside all non UCITS (AIF) funds; and
  - arguably many retail investors will wish to have access to AIFs and it restricts their investment choice if they are prevented from doing so. Currently, they may have limited access to them, for example under other products, such as via pension vehicles which are professionally managed.

Whilst there may be no appetite to undertake a fundamental review of the scope of the UCITS Directive for retail investors, the borderline between UCITS and AIFs is likely to be one which is continually tested. Looking at how AIFs might be promoted to retail investors, or for retail investors, will likely be an increasingly common purpose.

New specific types of fund vehicles, EuVECAs, EuSEFs and ELTIFs, have each been introduced with a view to assisting fund managers to respond to particular challenges regardless of the fact that they contribute to the untidy borderline between UCITS and AIFs. Will they be of use?

Each of the new types of fund vehicle, EuSEFs, EuVECAs and ELTIFs, should offer asset managers potential to play a larger role in alternative financing arrangements – something which is much supported under the EU's Capital Markets Union (CMU) initiative.

However, each of the specific types of product introduced recently, EuVECAs, EuSEFs and ELTIFs, has its own particular challenges. Strategies for making each of these products work better are under discussion. As the UK FCA has commented:

"*To some extent they should help rebalance any unintended consequences of AIFMD regulation on European venture capital and private equity investment.*"[1]

- We have encountered several instances where clients have been keen on the proposition of an EuVECA, only to find that the specifics prevent them from choosing that option and benefitting from the low entry level regulation which would apply to its AIFM. Certainly the revisions to, and extension of, the qualifying portfolio undertakings definition for EuVECAs would be of assistance.

  The UK HM Treasury proposal[2] that the Commission considers allowing EuVECAs to originate loans to qualifying portfolio undertakings without requiring equity investment, and increasing the proportion of capital which can be used for loan origination, might also be helpful.

  EuVECAs have the potential to be particularly attractive as a start-up route for new private equity managers, but the need to introduce the EuVECA framework perhaps goes to evidence the overregulation which is being introduced under AIFMD – or perhaps the need for higher AIFMD thresholds?

- From December 2015, ELTIFs have been available but, so far, there seems to have been limited interest in their take-up.

  In theory, ELTIFs should provide a useful long-term fund structure which benefits from a retail passport. The notion that retail investors should only wish to invest in open-ended funds has long been a somewhat illogical position. Retail, as well as institutional investors, need to make long-term savings. Provided individuals are aware of the lock-in nature of the investment, what should prevent them making a long-term commitment? But is the ELTIF framework right?

Perhaps it should not be for regulation to dictate what should suit in particular areas? New regulatory frameworks for product can have good intentions but, as we have seen with EuVECAs, they can introduce new straitjackets for a product which are not ideal for the product concerned, and so necessitate early amendments.

In various respects, there may be a benefit from taking a more holistic view on: "*What product is required for which target market?*" This question may be one which is best answered by fund managers – so they (as the product provider), and the investors (as the product purchaser) decide what to provide and what to buy.

- **What should happen with the third-country provisions?**

  When the AIFMD Level 1 text was settled, one of the most contentious issues concerned the third-country provisions. It was so contentious that it ended up with certain provisions (Articles 35 and 37–41 of the Directive) not being implemented from the outset. The question now arises: should they be switched on?

  The AIFMD is intended to provide both management and marketing passports but currently only does so for EU AIFMs and AIFs. ESMA was to advise the Commission in 2015 on whether or not Articles 35 and 37–41 of the Directive might be activated whereby there may be a passport available to non-EU AIFMs and AIFs (in place for the existing need to comply with the national private placement regimes (NPPR) under Articles 36 and 42). ESMA duly did so, but on a very limited basis in July 2015. In ESMA's 30 July 2015 Opinion, the "no obstacles" indications were provided for only three countries: Guernsey; Jersey; and Switzerland. This is to be gauged against the indication from ESMA that it had identified 22 countries that are domiciles of non-EU AIFMs that market AIFs into Member States or domiciles of non-EU AIFs marketed to Member States.

  Not surprisingly, the European Commission, in December 2015, issued a letter which asked ESMA to produce a further Opinion by 30 June 2016, so that the Commission can take a decision when a sufficient number of third countries have been appropriately assessed. By this date, ESMA is due to complete:

  - the assessment of three countries, the USA, Hong Kong and Singapore, which were selected for the first wave of six but for which no definitive advice was provided in the 2015 Opinion.

    Given the predominance of third-country fund structures – notably hedge funds – in the Cayman Islands, it is not surprising that the Cayman Islands Government is introducing amendments in order to create a compliant regime and the Commission is indicating that the Cayman Islands should be in the batch of jurisdictions in respect of which Opinions needed to be completed before the European Commission reaches a decision on extending the AIFMD passport to managers and funds established in third countries.
  - the assessment of a further six third-country jurisdictions selected for the second wave, Japan, Canada, Isle of Man, Cayman Islands, Bermuda and Australia.

  The question now is whether in fact fund managers with funds domiciled in all these jurisdictions wish the Article 37 provisions to be switched on. We certainly have much anecdotal evidence of fund managers indicating that they would, for their offshore product range, prefer to continue with an effective NPPR regime.

  The irony is that, for many funds in third-country domiciles, they might likely prefer the NPPR regimes to continue and to be improved. There is a lack of enthusiasm for switching on Article 37 provisions – certainly if this means switching off the NPPR possibility.

  Progressing the Article 37 provisions and stopping the NPPR regimes would likely prevent some products being promoted to European investors. Many third-country AIFMs might well undertake a limited private placement offering but not wish to undertake the full exercise should there need to be a non-EU AIFM authorised and compliance with AIFMD provisions. This might in fact result in some fund managers deciding not to promote within the EU. This would then reduce investment choice for European investors.

- **How should systemic risks be addressed?**

  It is too early to say how the systemic risk issue(s) will be addressed.

  AIFMD clearly imposes obligations on the fund manager to put in place liquidity management requirements and stress tests, particularly for when there are open-ended or leveraged funds in question. The results of stress tests must then be reported to the relevant regulator and ultimately passed on to ESMA. The main concern though from the 2011 G20 leaders meeting was a much broader initiative regarding systemically important financial institutions.

  At least the debate on the position for asset managers has moved on to look at specific activities rather than simply certain types of firm. Until there has been further analysis, both the Financial Stability Board (FSB) and IOSCO have jointly agreed to put on hold the entity based assessment methodology work and, instead, undertake further analysis on market wide activities-based solutions.

  The FSB indicate[3] that "a key deliverable" agreed at its meeting on 30/31 March 2016 comprises elements of a public consultation to take place in mid-2016 on policy recommendations to address structural vulnerabilities from asset management activities. The intention is to finalise these recommendations by the end of 2016.

  The policy recommendations, due for consultation in 2016 are being designed to address risks posed by:

  - funds liquidity mismatch – the possible mismatch between the liquidity of fund investments and the terms and conditions for redemption of fund units;
  - leverage within funds – obviously focusing on the high levels of leverage in some funds;
  - operational risk and challenges in a situation where there is to be a transfer of investment mandates from a fund manager in a stressed condition to another manager; and
  - securities lending activities of asset managers and funds.

  The FSB is also encouraging authorities to consider the use of stress testing to assess the individual and collective ability of funds to meet their redemptions under stressed market conditions. Increased information on liquidity and leverage risk across asset managers will be an essential tool for understanding the financial stability risks posed for the financial system.

  Taken together, these recommendations are expected to make a wide range of markets more resilient.

  So the entity based assessment methodology work is deferred for now but is still on the agenda.

  Once the above is progressed the FSB, jointly with IOSCO, will conduct further analysis and finalise the assessment methodologies for identifying non-bank non-insurer globally systemically important financial institutions (NBNI G-SIFIs), with a focus on any residual entity-based source of systemic risk from distress or disorderly failure that cannot effectively be addressed by market-wide activities based policies.

So there are reasons for optimism in relation to the regulatory framework for AIFMs, but it is important that there is engagement on how investment funds regulation, including that under AIFMD, should develop. There must be a constructive ongoing dialogue between the regulators and the regulated as to how to work with AIFMD, and other related regulatory initiatives, to improve regulation of investment funds so as to ensure that it is fit for purpose.

Facilitating new product offerings

To return to the key theme mentioned at the beginning of this chapter: we suggest that it is important that regulation for funds (of any type) does not constrain fund providers from deciding what product to offer in response to demand from investors. Regulation should not of itself constrain effective operation of old business models or prevent creation of new business models.

Thankfully, despite all the ongoing talk of regulation, this year most of the discussion has surrounded appropriate fund structures for today's market place and, as part of this, whether there is a need for regulatory input.

Current topics for discussion include:

- **Liquidity challenges**

  Certainly liquidity and managing liquidity is a key area of focus – for fund managers, investors and regulators.

  These issues are also being considered particularly in the UK in the Financial Policy Committee, a Committee of the Bank of England. It is interesting to note that there is a perceived increase in the risk due to the growing importance of open-ended mutual funds – focusing on the problems of redemption requiring liquidity to meet redemptions which might be out of line with the liquidity characteristics of the assets held by the fund. 2016 will certainly see continued exploration of how fund and market liquidity issues should be addressed by the FSB, IOSCO and the UK FPC.

  We suggest that it is important that the regulators do not take over such as to prevent fund managers and investors finding their own equilibrium as to how best to achieve appropriate liquidity and devise liquidity management policies. The UK FCA's good practice guide[4] issued in February 2016 regarding open-ended investment funds in the fixed income sector is a good example of highlighting best practices introduced by investment management firms to improve their own liquidity management. Key areas to address are tools, processes and underlying assumptions which require continual reassessment; operational preparedness and a high degree of reassurance that tools can be implemented smoothly when required; and clear and full disclosure to investors.

- **Role of funds in alternative financing**

  Potentially there are larger roles for asset managers to play in the alternative financing space. The EU's Green Paper on Capital Markets Union (CMU) includes various areas of potential for asset management elements. So there should be a bigger role for asset management to play not only in the traditional investment space but within the general financing space.

- **New long-term savings demands**

  There is so much development in the marketplace, particularly for long-term savings for individuals, notably where the risk is shifting from their employers to the individuals to make their own pension provision on a defined contribution basis, that the potential role for asset management solutions is clear.

In relation to each of the issues identified above, the recurring theme in discussions will likely be the benefit of allowing fund managers some freedom: freedom to utilise national private placement regimes; freedom to put some retail clients into AIFs, for example as a MiFID manager deems appropriate (one wonders if the UK restrictions are unduly limiting, having severely narrowed the ways of promoting non-readily realisable investments, which includes all manner of unregulated collective investment schemes and AIFs, to retail investors); freedom to offer choice of product to a wide range of investors; freedom to respond to liquidity challenges; and freedom to design asset management solutions in the alternative financing space and for long-term savings and pension markets.

The regulators' focus is, quite rightly, on investor protection, but it is equally important to allow access to investment products. Particularly in the alternative investment funds space, and particularly when offered to professional investors, it should be important to ensure that product providers can offer a wide range of products and for investors to be able to choose from that range, and take responsibility for their own choices. Arguably, this is also the case for many products offered to more sophisticated retail investors. It might well be better to have the risk of some investors making the wrong choice rather than preventing all investors having a choice.

There are signs that, for products promoted to EU investors, there is greater consideration of choosing EU fund domiciles than non EU fund domiciles – which is encouraging. There is a risk though that overly prescriptive regulation may prevent fund managers being able to devise appropriate products quickly for new market demands. Overly prescriptive regulation in the EU may also prevent funds from being set up and/or sold into the EU.

Let us hope that AIFMD regulation does not develop so as to preclude what will be a key component of a successful evolvement of the AIF (and UCITS) products to be offered. The simple proposition remains that (well regulated) fund managers should have the ability to design and offer the product which they think investors wish to buy.

Endnotes

1. Paragraph 1 of the UK FCA's Response to the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services, February 2016.
2. Set out in paragraph 1.4 of HM Treasury's Response to the EU Commission: Call for Evidence on EU Regulatory Framework for Financial Services, February 2016.
3. See Financial Stability Board website for further details: http://www.fsb.org/2016/03/meeting-of-the-financial-stability-board-in-tokyo-on-30-31-march/.
4. See https://www.fca.org.uk/news/liquidity-management-for-investment-firms-good-practice.

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Kirstene is a financial services specialist and is Head of the Financial Services and Funds Group at Fieldfisher.

She advises leading players in the financial services market on legal and regulatory developments, particularly with regard to new investment funds, products and services.

Kirstene is best known for her advice on regulated funds but her practice has evolved with the globalisation of fund management businesses and covers a wide range of international funds and products, including Alternative Investment Funds of a variety of descriptions, and insurance and pension products. She also advises a wide range of clients on UK financial services regulation, including Financial Services and Markets Act 2000 (FSMA) perimeter issues, insurance and pension products, conduct of business issues and the impact of the implementation of EU Directives.

With over 25 years' experience in this sector, her leading expertise is acknowledged by UK and international legal directories. (For example: Kirstene is ranked in Band 1 for Open and Closed-ended Funds by *Chambers UK 2016*; she is endorsed as a leading individual in the PLC *Which Lawyer?* directory and as a leading lawyer by the *IFLR 2015*. Kirstene is endorsed as a prominent practitioner in the Guide to the World's Leading Investment Funds Lawyers.)

Kirstene is an immediate past Co-Chair of the International Bar Association (Legal Practice Division) Investment Funds Committee, and Chair of the International Bar Association's Annual Globalisation of Investment Funds Conference, remaining on the organising committee for its 27th year, being held in New York in May 2016. She is a member of the UK FCA's Legal Experts Group regarding implementation of the Alternative Investment Fund Managers Directive.

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