AIFMD: THE RISKS OF NON-COMPLIANCE

CONTENTS

INTRODUCTION

In December 2013, BNY Mellon surveyed the alternative fund community to assess the industry's state of readiness to implement the Alternative Investment Fund Managers Directive (AIFMD) with a specific focus on the risk and compliance requirements of the directive. This paper reviews the findings of our survey and gives focus to how the requirements for risk and compliance functions are being adopted.

Since 2009 there has been an increasing focus on the practicalities of risk and compliance management for funds. Starting with UCITS IV, (Directive 2009/65/EC), the European Union (EU) has been seeking to mandate, standardise and enhance the functions of risk and compliance. For example UCITS IV made reference to operational risk as a specific risk category to be considered. The recent proposed regulation of Money Market Funds (MMFs) in Europe includes specific proposals regarding stress testing for MMFs. As an industry we continue to evolve practice in this space, always having to balance the obligations of new regulations with practical concerns of resource, data and systems. To this last point, we wanted to explore how Alternative Investment Fund Managers (AIFMs) are translating the directive's requirements and to explore the challenges, practicalities and costs of meeting these requirements. In doing this we also wanted to explore the concept of independence for these functions and if there is a 'benchmark' for an appropriate and proportionate function. We encourage fund directors charged with good governance as well as compliance officers and risk managers to review this paper and to further their thinking in the debate.

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BACKGROUND

We are now three quarters of the way through the authorisation period for the AIFMD. By 22nd July 2014, fund managers wishing to market alternative investment funds inside the EU will need to have submitted their application for authorisation and be compliant. The scope of the directive is wide, covering nearly all collective investment vehicles which are not UCITS.

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The directive's objectives are principally to offer the investor enhanced protection and to create more transparency for the regulators so they can effectively govern the market's activity. The directive stipulates legislation on three significant components:

(i) The role of the depositary

(ii) The guidelines for reporting information to the regulators

(iii) The operational requirements for the AIFM, clarifying any delegation of duties and the creation of a risk management function

AIFMs shall hierarchically separate risk management functions from operating units and implement adequate risk management systems to identify, measure, manage and monitor all risks relevant to each AIF investment strategy.

Not surprisingly, risk management is actually a central theme to the directive and is one of the primary mechanisms to facilitate the attainment of greater investor protection and enhanced regulatory control. Article 15 of the directive (2011/61/EU) details, amongst other things, the following requirements for AIFMs:

Article 15 of AIFMD:

AIFMs shall functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management.

AIFMs shall implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.

Ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures.

Should the more stringent principles also be applied if alternative mandates are "more risky"?

The AIFMD risk management requirements are based upon the risk management principles of the UCITS IV directive established for collective investment schemes with more traditional mandates. However, the AIFMD requirements are not as prescriptive as the UCITS risk management principles, notably omitting direction on Value-at-Risk (VaR) guidelines and the need for daily risk monitoring. While this will be discussed in more detail later in the paper, there is a view that the legislation is contrarian in design – should the more stringent principles also be applied if alternative mandates are "more risky"?

In this context, our survey set out to explore the following hypotheses:

H1: The regulatory risk framework details a number of risk components, which require active monitoring by the AIFM. While some of the risk components are more readily tracked by the managers, the proposition is that firms are, on average, struggling to meet all of the requirements.

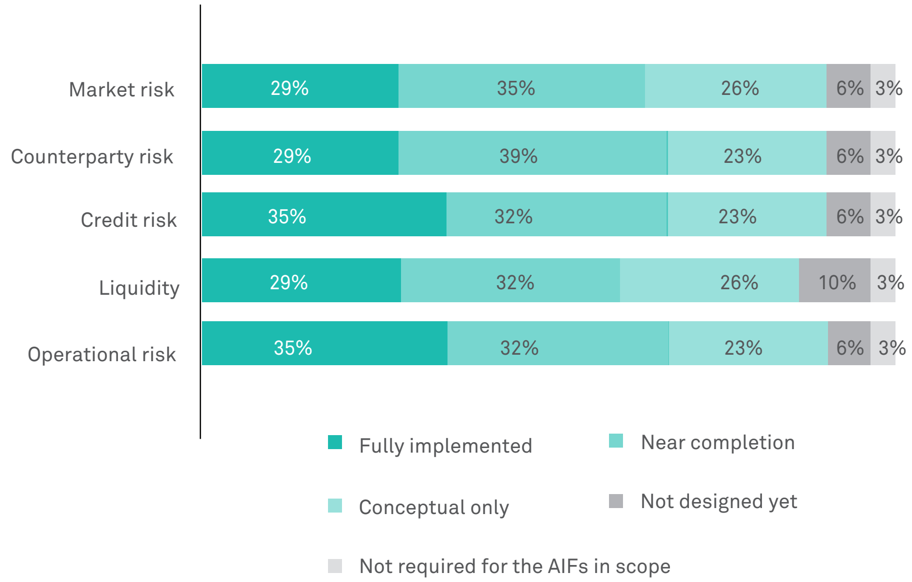
H2: The shortfall in compliance is not due to a knowledge gap, but rather a shortfall in the investment required to bridge data management issues, staffing and technology development

The results of our survey follow and are reported with the themes of: the industry's the state of readiness, the challenges and the associated costs the AIFMs are facing, the solutions being developed, and the practical interpretation of the legislation.

STATE OF READINESS
There is evidence that AIFMs are delaying their application process. In our December 2013 survey, only 12% had submitted their application with a further 7% expecting to by year-end. A full 81% of participating AIFMs had yet to submit applications. Taking into account the amount of time taken for in-house functions, external administrators and depositaries to fully prepare, and the time needed by regulators to review applications, at this stage there is a risk that many AIFMs will miss the July 2014 deadline. This suggests there will be a bottleneck of applications in Q2 of 2014, potentially putting administrators, depositaries, other third parties and the regulators under pressure to complete the necessary work and to process applications in time for the July deadline.

Bottlenecks are expected in Q2 of 2014 putting administrators, depositaries and regulators under pressure to meet the July deadline.

In terms of implementing the new AIFMD risk and compliance requirements, the industry appears to be making more progress. The majority (55%) have implemented, or are close to implementing, a risk management framework while even more (68%) have completed, or are near completing, their compliance framework. While this is at first encouraging, there is a trend in the survey responses which demonstrates a difficulty in moving this forward with close to a third having yet to advance beyond the conceptual stages in their risk and compliance monitoring solutions.



This is perhaps best illustrated by the responses relating to operational risk. 35% of participants have fully implemented their framework, but as we will see later, operational risk is also one of the most challenging areas to monitor on an ongoing basis. One possibility for this anomaly is that fund managers may be leveraging broader organisational practices, or leveraging their experience through UCITS to design their policy under AIFMD. More broadly, this may also be a function of the diversity of managers and mandates captured under the directive where perhaps the more straightforward strategies, such as relative value or long/short strategies are easier to implement through this process.

We now discuss the journey in moving from designing the framework to ongoing monitoring by considering the challenges, costs and the solutions AIFMs are deploying.

CHALLENGES

A key finding in the survey is the general practical difficulty the AIFMs face in supporting their risk framework on a day to day basis, with 82% facing issues in collating the appropriate data to make an informed assessment. On reflection this significant proportion is not surprising given the scope of the risk and compliance requirements. The regulation expects the AIFMs to monitor all material risks which may impact the fund across the components of market risk, counterparty risk, credit risk, liquidity risk and operational risk. In summary, the full spectrum of risk management.

The ESMA guidelines (Level 2 Technical Advice, 19 December 2012) articulate the requirement for AIFMs to establish quantitative and qualitative controls for the AIFMs within each of these components. While this technical advice is less of a burden than the Risk Management Principles issued for UCITS funds where the limits are prescriptive, there is still a desire to align practices across both AIFs and UCITS. ESMA also, recognising the potential range of investment strategies which will fall under AIFMD, directs AIFMs to employ stress testing as part of their risk management policy without specifying strict routines or risk models to follow.

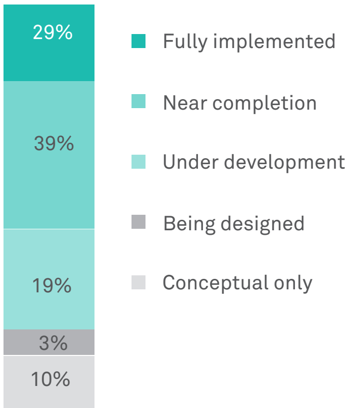
82% of respondents facing issues in collating appropriate data to make an informed assessment.

MARKET RISK

The traditional industry practice to stress testing market risk has been to employ a Value-at-Risk (VaR) approach. Deploying a VaR approach for the more complex mandates, which heavily utilise derivatives, is typically a resource intensive activity where the resources required cover not only the technology investment but also a large range of data points to model the individual terms of each contract. An AIFM which does not have access to a VaR capability today faces material investment, significant system interfacing and data management skills to support the ongoing process.

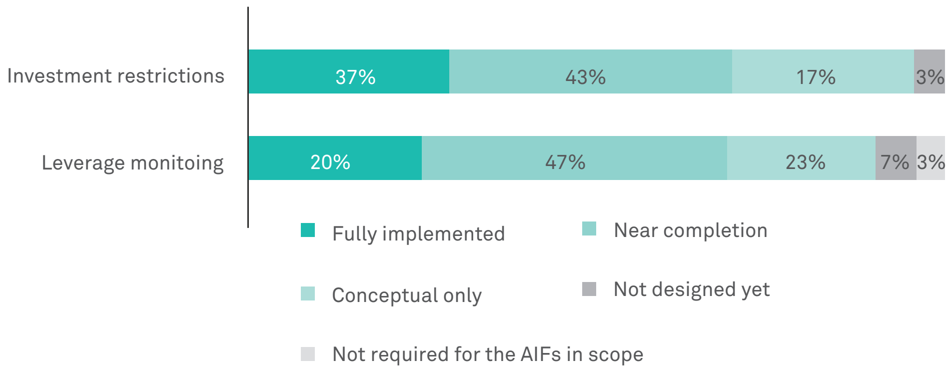
Perhaps in an attempt to alleviate this overhead, ESMA has also issued detailed guidance in the calculation of market risk exposure, which effectively attempts to offer all of the stakeholders a sense of the leverage within the AIF. Whether an AIFM employs VaR techniques or does not, the leverage requirement is mandatory for all AIFMs. Again, with the focus on the utilisation of derivatives, the calculations in themselves do not pose any theoretical problems. However, two practical challenges persist because the guidelines base the calculations on the market value of the underlying contracts. Firstly, most investment management systems (front office, accounting etc.) typically value derivative contracts to reflect the open position without any immediate association to the value of the underlying physical. Secondly, the Article 15 leverage rules permit AIFMs to reduce the fund exposure by netting derivative positions where the underlying is a common instrument. In reality, portfolio management decisions typically take more of a macro approach in netting exposure across investments, and while the directive is technically more accurate this can create data collation issues in referencing underlying securities across platforms.

Compliance Monitoring - Issuer Concentration



No doubt symptomatic from the contagion events of the market crash in 2008, there is an emphasis on monitoring counterparty risk and concentration. This traceability is present in the regulation of UCITS funds where there are strict rules on monitoring concentration across both vanilla securities and OTC positions. However, the ESMA guidelines for AIFMs are not as stringent enabling AIFMs to express their own appropriate limits for the funds, but this does not negate the need for a robust compliance system. Below is a breakdown of the level of completeness of participants' compliance solutions. Again, this highlights how, while the majority are at or close to completing compliance monitoring solutions, 20% and 30% of respondents respectively have yet to advance beyond conceptual stages in their investment restrictions and leverage monitoring systems at this stage.

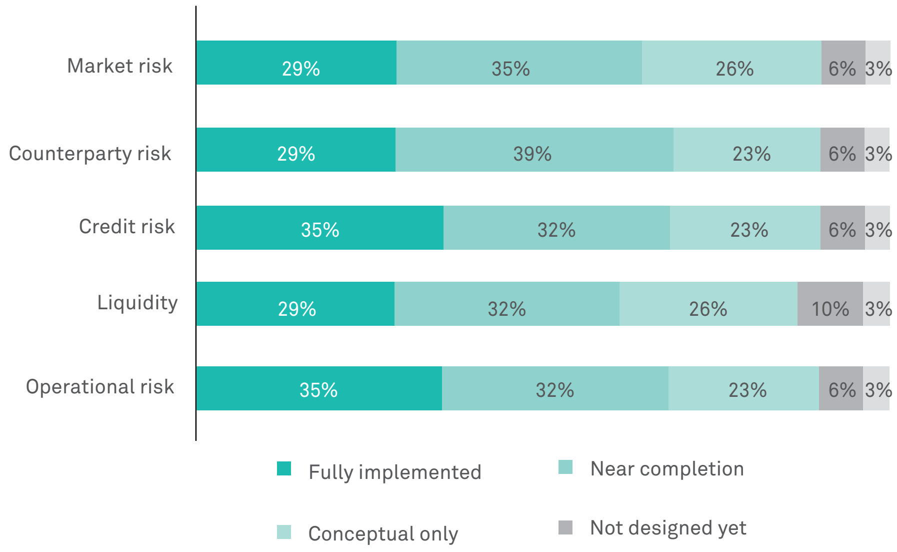
20% have yet to advance beyond the conceptual stage in their investment restrictions.



LIQUIDITY RISK

The regulators are also concerned with the liquidity profile of the AIFs, highlighting liquidity risk in Article 16 of the directive where they instruct AIFMs to monitor the liquidity profile and redemption policy under normal and stressed market conditions. 29% of the AIFMs in our survey have implemented their liquidity risk approach with a further 32% nearing completion. This represents a clear division in the industry and is possibly due to the range and complexity of the AIF investment mandates – a relative value, long/short strategy will have sufficient market data through the exchange to monitor trading volumes (for example), but this is not as readily accessible to say, a manager executing an asset backed security mandate.

The regulators have at least acknowledged this by providing a flexible framework in the directive for monitoring liquidity.



68% of respondents see challenges in the Operational Risk monitoring category

RISK ACROSS THE ORGANISATION

Monitoring operational risk presents risk managers with a fundamental challenge as it is a broad and less defined risk category. This is expressed by respondents, many of whom (68%) see challenges in the Operational Risk monitoring category. ESMA put forward some broad categories for AIFMs to consider as part of their operational risk management:

- *failure of the information technology that directly or indirectly connects the AIFM to the market*
- *risk of key persons leaving the firm*
- *failure in the investment reconciliation process performed by fund administrators*
- *fraud*
- *failure in trading, settlement and valuation services*

While the AIFMs are managing to create the appropriate risk culture within their business and empowering their risk officers, there does appear to be a practical issue in creating the risk management function. A quarter of the survey participants express difficulty in hiring experienced staff to fulfil these roles. It is not clear whether this is due to a limited talent pool with the regulation being relatively new, or whether this is a question of scale and resource where the smaller AIFMs cannot justify the appropriate spend to attract qualified personnel.

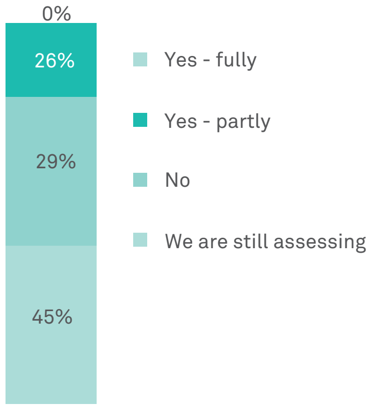
COSTS

Costs relating to AIFMD

The industry has had time to make an assessment of the total cost of gaining authorisation and implementing the directive. The mean expected total cost of implementation is USD300,000, in line with the USD305,000 mean from the first survey we conducted in July 2013.

Fund managers are biding their time deciding how to allocate the cost of AIFMD compliance with some 45% still assessing whether the costs should be borne by the firm or by the fund and therefore impacting the total expense ratio (TER) incurred by the investor.

Costs related to AIFMD

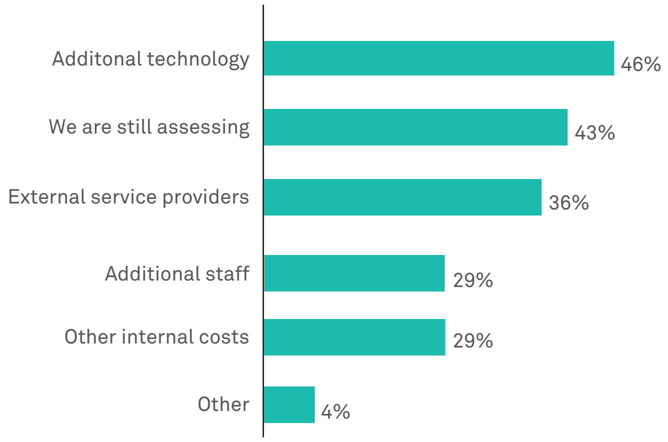


Of those who have made their decision, a little under a half will be passing on some of the increased costs to the fund resulting in higher costs for investors. Interestingly, none of those surveyed expect to pass on all additional costs to the funds. While there are still a surprisingly high number of participants who are assessing how their costs will be impacted, this marks an encouraging trend for investors: In July 2013, 88% of survey participants expected to see TERs increase as a consequence of AIFMD.

93% see the increasing costs to support risk and compliance data as challenging. 46% see the cost of additional technology increasing as a consequence of compliance and 43% are still assessing where additional costs will lie.

COSTS RELATING TO RISK AND COMPLIANCE

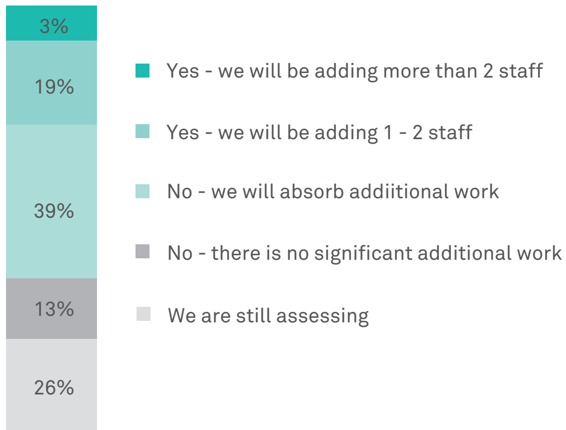
Almost all respondents, (93%) see the increasing costs to support risk and compliance data as being challenging. 46% of respondents see the cost of additional technology increasing as a consequence of compliance with 36% of AIFMs in this survey expecting to incur additional cost for external service providers. Once more, 43% of respondents are still assessing where additional costs will lie.



More than a third of fund managers (39%) have decided that they are adequately equipped to handle the administrative requirements of AIFMD with their existing staff. Existing resources will absorb the pressure of the additional regulatory reporting requirements in areas like market risk counterparty risk, credit risk, liquidity risk and operational risk. This suggests that they are seeking to minimise the cost burden of compliance, while at the same time believing that the in-house department is equipped to fulfil reporting obligations with related data and systems.

Some firms (13%) indicate considerable confidence in their ability to manage the process of compliance with no expectation of significant additional work under AIFMD. This indicates that existing compliance systems already cover the data which firms will be required to gather and provide under the directive. One may infer that such firms have no intention to hire additional staff.

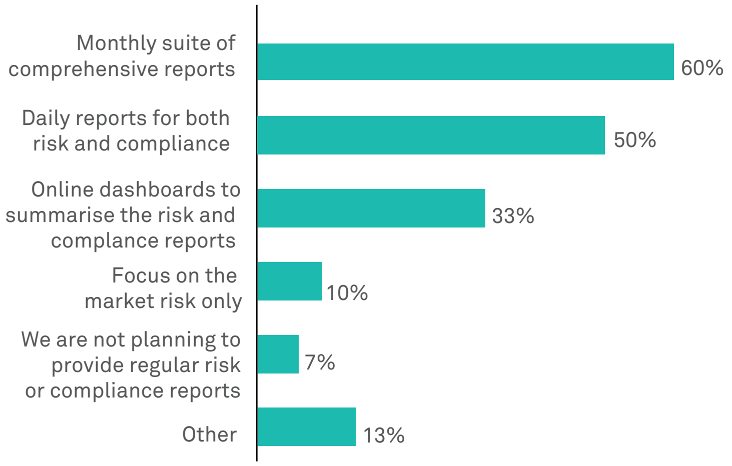
However, fewer than 20% of firms plan to recruit one or two staff to cover AIFMD compliance. Those firms may have decided to address additional requirements for regulatory reporting in-house rather than use an external administration service provider.



IMPLEMENTING SOLUTIONS

The survey respondents have a clear preference for handling their regulatory reporting in-house. Some two thirds of respondents indicated this option with 37% of the respondents still assessing their approach to regulatory reporting. They will be aware that this decision has cost considerations and fund managers will be assessing relative costs of using Administration, Depositary or a different service provider to perform the regulatory reporting role. Fund managers may also be aware that in-house departments hold considerable data and monitoring systems and this can be leveraged for the purpose of AIFMD compliance.

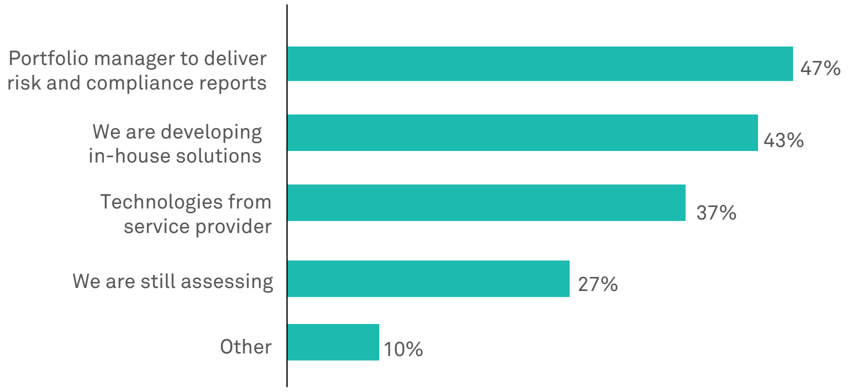
The relative importance of the risk and compliance monitoring requirements within the directive comes through in our survey where the great majority of respondents



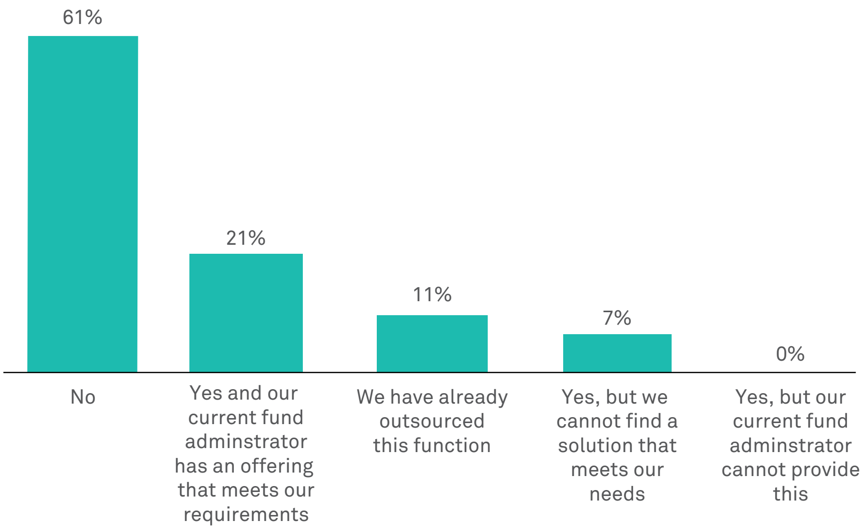
6 in 10 are also looking to do daily reports and the other 4 in 10 are planning online dashboard summaries.

(83%) are looking to implement best practice through either daily reports, or online dashboards to summarise the potential threats to the funds.

While fund managers are seeking to manage their way through the AIFMD requirements as much as possible on their own, there is some suggestion that finding necessary risk metrics and compliance monitoring is a challenge for in-house teams. The evidence for this is that 37% of respondents are using a service provider to provide technologies required to monitor compliance and keep the firm updated.



Furthermore, 39% of respondents are to some extent outsourcing their risk reporting and compliance reporting requirements to a third party provider.



Our survey results show that the risk management function is still being aligned to the front office with 47% of respondents reliant upon the portfolio management function.

DEMONSTRATING INDEPENDENCE

While the investment industry increasingly recognises the importance of creating a robust risk management culture, the creation of a functionally and hierarchically separate risk management function may still be a challenge to some alternative investment houses. Historically, within the industry this function has been aligned to the front office and our survey results indicate this association still persists with 47% of the respondents being reliant upon the portfolio management function. This reliance is based not only on the front office technological capability to calculate risk and compliance, but also a dependency on the sourcing of the underlying data. The question remains then, does this reliance upon the portfolio management function fit within the spirit of the directive?

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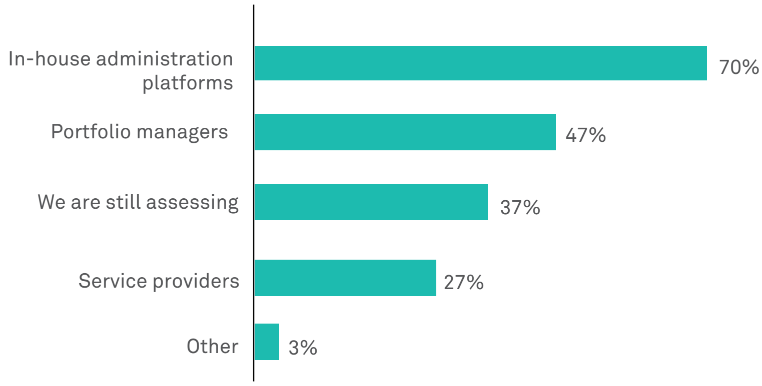


While risk managers may be appointed with the necessary means to fulfil their duties, or remunerated for maintaining their risk controls, there is an argument to suggest these steps become academic if the basis of their information is from the portfolio management function which is charged with performance related objectives.

CONCLUSIONS

Our survey set out to test two hypotheses, which centred on the theory that AIFMs are struggling to meet all of the risk management and compliance requirements; and this struggle is due to a lack of investment to facilitate data management issues, staffing and technology development.

On a positive note, the industry appears to be making headway with implementing their risk and compliance frameworks; recognition that this is an important piece of legislation which requires dedicated focus and resource. It is also encouraging to see AIFMs succeeding in the creation of an appropriate risk culture across the firm, which is no doubt symptomatic of the Global Credit Crisis and the subsequent pace of regulatory change. The survey respondents also appear to be mindful of passing on all of the costs of compliance through to the investors (as a contributor to the total expense ratios of the funds).

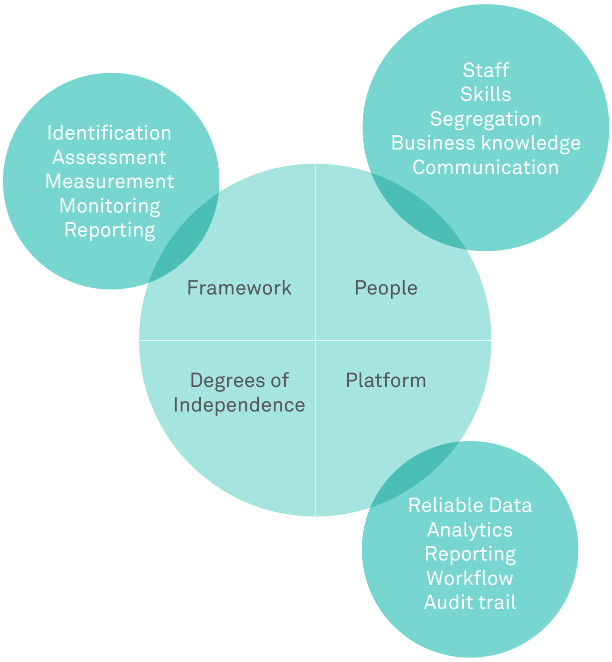
However, there are evidently clear practical challenges with 82% of AIFMs facing issues in collating the appropriate data to make an informed assessment when monitoring the risk and compliance requirements. There is also the potential for the limited impact assessment to the TERs changing with a third of the respondents still in the conceptual stages of design and with 27% still assessing the full costs.

While this discussion has focused on AIFMD and referenced the UCITS legislation, there are also proposals in Europe to implement risk management controls for money market funds and to further improve the diversification of collateralised securities, which stimulates further questions – will fund managers hire the additional resources and simply accept the cost, or will they identify wider roles to bring value? Perhaps the market sentiment may continue to develop to the point where institutional investors encapsulate the risk and compliance information as part of their regular due diligence process and the capability of the risk management function becomes a differentiator.

While some of the formal regulatory submissions are currently only annual statements (for example, Annex IV requirements under AIFMD) there is scope in the medium term for investors to begin to leverage this information as well. It is not unreasonable to expect investors to request this information as evidence of the governance processes and practices, which may in turn create a demand for evidence on a more regular basis.

The level of regulatory requirements is clearly on an upward trajectory and there is a potential divergence between the intent of the regulation and the practices of the industry. If the aims and objectives of the AIFM directive fall short then arguably the end investor is not protected. Are they still carrying the risk, or are the AIFMs and the industry exposed?

In developing this paper we have been asking the question is there a benchmark for an independent, appropriate and proportionate risk and compliance function. In considering this we have made reference to a number of documents include the 'EFAMA Risk Management Paper' (February 2011), the ALFI 'Risk Management Guidelines' revised 2012 and the directives and implementing directives from the EU. In doing this we have developed the following model.



In an ideal world the risk and compliance functions would demonstrate some form of independence across this framework. We see in the results in the survey firms showing that firms are working towards this, but conclude that on balance there is still work to be done. Respondents have touched on some the challenges and we must also acknowledge that the AIFMD is only one of several regulations that firms have to deal with that require investment, change and resource. Therefore we expect to see the capabilities of firms mature over time but in parallel more requirements from the regulators. We would like to hear more from firms about their views on this survey, our model for assessing the capabilities and maturity of risk and compliance functions and how firms are assessing what is appropriate and proportionate.

RESEARCH METHODOLOGY

This research was conducted using a mixed research methodology of online research and telephone interviews from 10th to 29th December 2013.

A total of 52 Alternative Investment Fund Managers participated in the research from Europe, Asia, the US and Latin America from companies who operate or are considering operating an alternative fund that would be covered under the AIFMD. Respondents of this survey have an accumulated total of over USD 4 trillion of total assets and over USD 20 billion of assets covered by the AIFMD. Just over one third operate more than five AIFs.

Please note that the standard convention for rounding has been applied and consequently some totals do not add up to 100%.

BNY MELLON CONTACTS

Paul North, Head of Product Management, EMEA
Email: paul.north@bnymellon.com
Tel: +44 207 163 5455

Graeme Porrett, Senior Product Manager, Global Risk Solutions
Email: graeme.porrett@bnymellon.com
Tel: +44 207 163 3027

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