Are Hedge Funds Ready for the AIFMD?

Following the implementation of the Alternative Investment Fund Managers Directive (AIFMD), Graeme Terry presents the results of our survey of hedge fund managers, analyzing which managers will be affected by the directive and how prepared they are, as well as investors' views on the regulation.

Following years of discussion and amendments, the Alternative Investment Fund Managers Directive (AIFMD) was finally implemented into national law by EU member states on 22 July 2013. New alternative investment fund managers (AIFMs) will be required to comply with the directive going forwards, although existing AIFMs will have until 22 July 2014 to apply for authorization to their regulator. The directive is aiming to provide harmonized regulatory standards across all alternative investment managers and more specifically it requires hedge fund managers to obtain authorization, meet on-going reporting conditions and comply with transparency requirements in order to manage and market hedge funds within the EU.

The AIFMD is designed to increase investor confidence in hedge funds, through the reduction of systematic risk and the enhancement of investor protection. It will lead to a number of changes for hedge fund managers, and detractors of the directive have suggested this will lead to unnecessary additional costs and complexity. Key requirements of the directive include the appointment of a depository, reporting requirements, separation of risk management and portfolio management functions, an appropriate and regularly updated due diligence process and remuneration controls.

Despite the concerns of a number of firms, the AIFMD could have a positive effect on the hedge fund industry by providing a uniform regulated structure. AIFMD-approved managers will be able to passport their funds across the whole of the EU, in a similar fashion to the current UCITS hedge fund passport. This will lead to a consistent standard for all hedge funds marketed in Europe and could present further opportunities for growth in the hedge fund industry in the future as investors look to tap into the regulated AIFMD "brand".

Impact of the AIFMD on Hedge Fund Managers

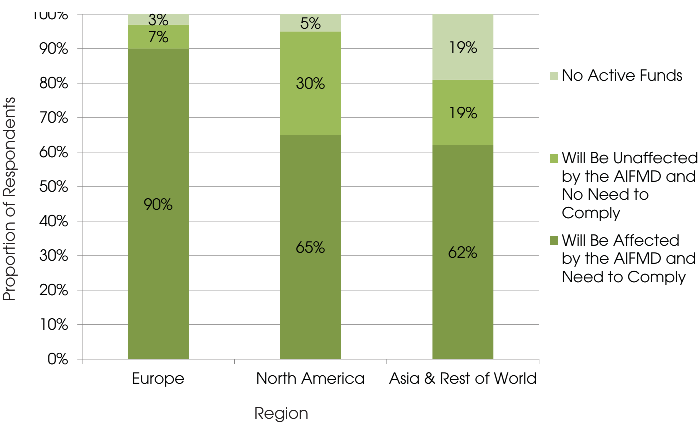
Throughout June and July, Preqin conducted a survey of more than 220 hedge fund managers (including both direct hedge fund managers and fund of hedge funds managers) in order to assess whether or not these managers are ready for the AIFMD. All AIFMs within the EU will be obliged to apply for authorization before 22 July 2014; Preqin's Hedge Fund Analyst currently contains profiles for 892 active hedge fund managers based within the EU. These managers will have to update their processes accordingly to make sure they are ready for all of the requirements of the directive. Other countries such as Norway, Iceland and Liechtenstein, which are member of the European Economic Area but not the EU, are likely to sign up to the directive, and Switzerland has amended its own regulations in order to correspond to the AIFMD.

As the AIFMD will apply to any non-UCITS fund managed or marketed in the EU, North American managers marketing to EU investors will also be affected by the directive. The results of our survey suggest that 65% of North American fund managers feel they will be affected by the AIFMD, as shown in Fig. 1. With 2,890 active hedge fund managers tracked in North America by Preqin's Hedge Fund Analyst, this could amount to a significant number of managers needing further advice on compliance. These managers will face a phased compliance period until the current placement regime expires in 2018. A number of US-based managers plan to rely on 'reverse solicitation' in order to continue doing business with European investors and these firms will need to ensure that all documents do not contain anything which counts as marketing in order to keep in line with the regulations.

Fig. 2 and Fig. 3 show the results of our survey excluding those managers that are unaffected by the AIFMD. The overall results displayed in Fig. 2 show that only 22% of respondents affected by the AIFMD feel that their funds are already AIFMD-compliant, with a further 22% expecting their funds to be compliant by the end of 2013. A significant number of managers (40%) are waiting for final changes and guidance from their regulator, highlighting the fact that there is still a lot of uncertainty regarding the implementation of the directive and managers are looking to their local regimes to guide them. A small number of managers (3%) stated that they will not be ready for the compliance deadline.

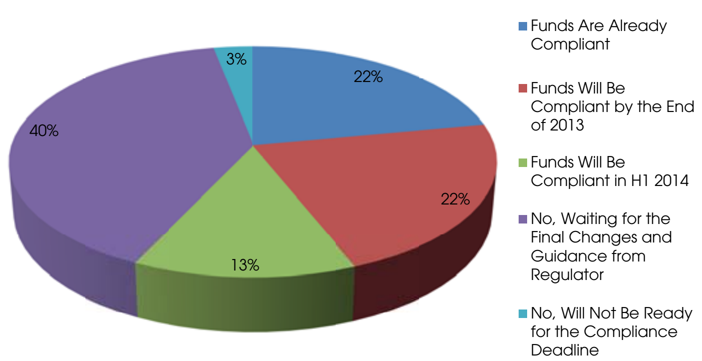
The breakdown of survey responses by region is shown in Fig. 3 in order to assess the differences in preparation between European

Fig. 1: Proportion of Hedge Fund Managers In Each Region Which Stated They Will Need to Comply With the AIFMD



Source: Preqin Hedge Fund Manager Interviews, June - July 2013

Fig. 2: Are Fund Managers Ready for the AIFMD?



Source: Preqin Hedge Fund Manager Interviews, June - July 2013 managers and their North American counterparts. There is a noticeable difference between the two groups, with 64% of European respondents expecting to be ready for the AIFMD by H1 2014, compared to just 51% of North American managers. A substantial number of managers in both regions are awaiting further guidance from their regulator, while a higher proportion of North American respondents stated they would not be ready for the deadline. North American managers will have more time to prepare for the directive due to the phased compliance regime for non-EU managers and as such, they will only have to comply with certain aspects of the directive initially.

When looking at the responses in terms of the assets under management of reporting firms, it is clear that larger fund managers, with more than $1bn in assets, are better prepared for the implementation of the directive, with 65% of respondents expecting to be ready by the end of 2013, as shown in Fig. 4. These firms are likely to be further ahead in the implementation process as they will have much greater resources, and will be more likely to have access to large firms able to fulfil the depository requirements and have the internal resources to deal with the new reporting requirements. These firms are also likely to be able to get the assistance from top advisory firms to help them understand the regulations surrounding the AIFMD and the necessary changes to ensure compliance. Smaller North American managers are less likely to market within the EU and so may fall outside the scope of the directive, while managers with less than €100mn in assets will also be exempt from the directive.

Impact of the AIFMD on Hedge Fund Investors

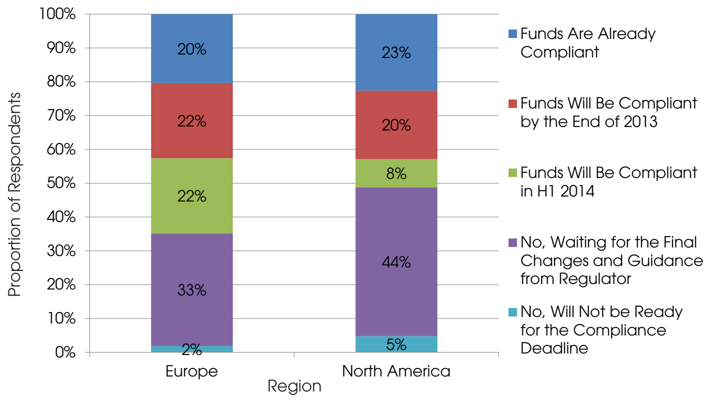
In June 2013, Preqin interviewed more than 90 prominent institutional investors in hedge funds in order to assess their current views on the industry. The vast majority of these investors (94%) said that recent regulations had yet to have any effect on their hedge fund allocations, although many indicated concerns over how they would affect the industry in the future. Of the investors interviewed, 35% said that regulations are positive for the hedge fund industry, while 22% believe additional regulation to be negative, as shown in Fig. 5. The remaining 43% of investors said they were unsure about recent regulatory proposals, suggesting that they are waiting to see how the proposals are implemented before forming a definitive view. A previous Preqin study in December 2012 indicated that 49% viewed regulation as positive for the hedge fund industry, suggesting that more investors have become unsure about the benefits of the proposed regulations in the first half of 2013.

Having a consistent regulated standard for hedge funds along with more transparent reporting could help institutional investors in assessing quality managers. One of the main concerns regarding regulations among institutional investors centres on a lack of clarity and there is a fear that this could lead to a tougher environment and more complications. This is particularly true in the case of the AIFMD as each member state has a different adaptation of the directive, meaning that investors are unclear about how the directive will be implemented within each European country. Many investors within the EU are also concerned that the AIFMD will impact the choice of funds available to them.

Outlook

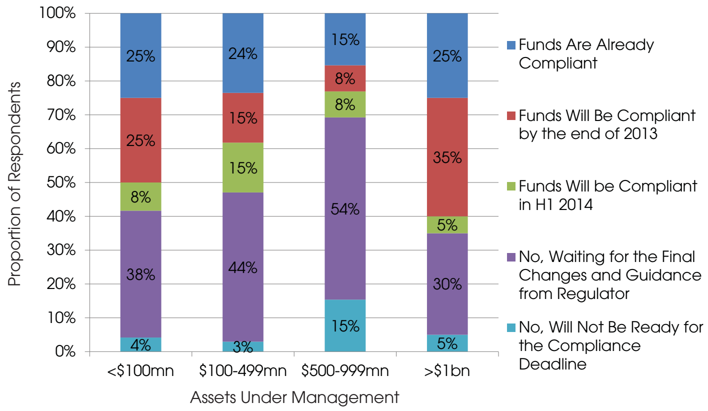
With the imminent launch of the AIFMD, the majority of hedge fund managers still have work to do in ensuring their funds are fully compliant with the regulations. So why should non-EU managers bother with the AIFMD? Preqin's Hedge Fund Investor Profiles tracks 711 investors based within the EU, representing 17% of the investors tracked by Preqin. Combined, these investors represent 22% of the capital invested by institutional investors in hedge funds today (Fig.6); a significant portion

Fig. 3: Are Fund Managers Ready for the AIFMD?: Breakdown by Region



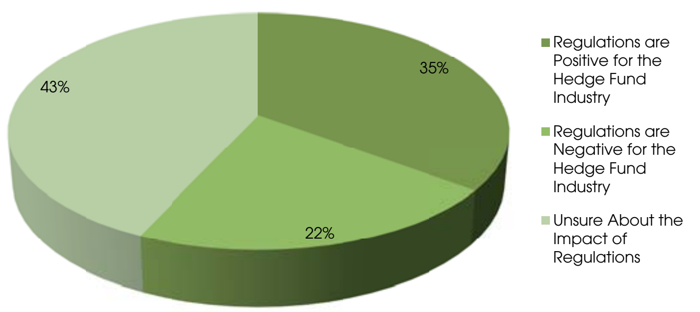
Source: Preqin Hedge Fund Manager Interviews, June - July 2013

Fig. 4: Are Fund Managers Ready for the AIFMD?: Breakdown by Assets Under Management



Source: Preqin Hedge Fund Manager Interviews, June - July 2013

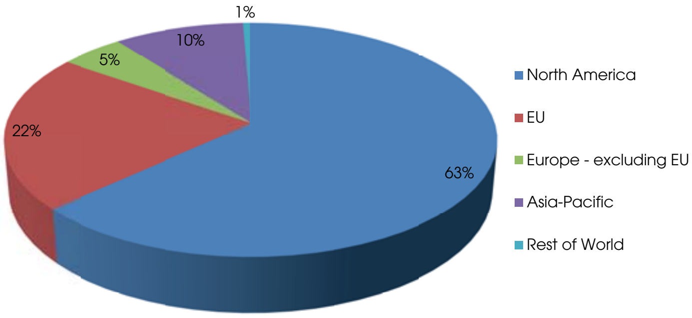
Fig. 5: Hedge Fund Investor Perceptions of Regulations Launched in 2011 - 2013



Source: Preqin Hedge Fund Investor Interviews, June 2013 of the $2.3tn industry. Eighty-three percent of these investors are open to investment opportunities in the hedge fund space globally; therefore those managers outside of the EU considering the financial and time implications regarding compliance may be encouraged to comply, in order to tap into a region which can potentially be a lucrative source of funding for a hedge fund. For investors in the region, it is reassuring to see such a large group of the survey respondents looking to comply with the directive (72% of the fund managers surveyed), which therefore reduces the impact of the AIFMD limiting the amount of funds available for them to invest in.

European managers seem better prepared than their North American counterparts at this stage and the phased compliance period for non-EU managers means that a number of North American funds are likely to see the initial impact of the regulations before altering their processes. Institutional investors have still to be convinced about the benefits of regulation in the hedge fund industry and they will be watching closely to see the effect that the AIFMD has on fund managers. With uncertainty still surrounding the impact of the directive, it may be 2014 before it is possible to assess the full impact of the AIFMD on the hedge fund universe.

Fig. 6: Proportion of Institutional Capital Invested in Hedge Funds By Investor Location



Source: Preqin Hedge Fund Investor Profiles

Subscribers to Preqin's Hedge Fund Analyst can click here to view detailed information on the 892 EU-based hedge fund managers affected by the AIFMD.

Subscribers to Preqin's Hedge Fund Investor Profiles can also click here to view profiles for 711 EU-based investors in hedge funds.

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