AIFMD

COMMON MISPERCEPTIONS SURROUNDING THE RISK MANAGEMENT REQUIREMENTS OF AIFMD

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Following the end of the transitional relief period last year, we have seen that fund managers operating in Europe have now begun to focus on implementing the requirements of the Alternative Investment Fund Manager Directive (AIFMD or the Directive). There has been much discussion and consternation about the reporting and disclosure aspects of the Directive. While AIFMD impacts all aspects of an alternative investment firm's operations, including firm governance, marketing and operations, we have found that one area in particular that is not well understood is the risk management requirements for the Directive. In this article, we cover some of the most common misconceptions surrounding the risk management requirements and suggest some solutions that managers may want to follow to achieve compliance with the Directive that will pass both regulator and investor scrutiny.

"CAN WE JUST APPOINT A STAFF MEMBER TO BE RESPONSIBLE FOR RISK COMPLIANCE?"

Managers who register in a European jurisdiction as alternative investment fund managers (AIFMs) and fall under the auspices of the Directive must comply with the full range of requirements, including risk management. While the interpretation and requirements of the Directive may vary slightly from jurisdiction to jurisdiction, AIFMD requires AIFMs to have an "independent risk management function". Some managers may be operating under the premise that it is sufficient for the firm's chief investment officer or a portfolio manager to oversee investment risks. This approach does not meet AIFMD compliance.

The Directive requires managers to have a risk management capability that is "functionally and hierarchically" separate from the firm's investment or portfolio management function. If they do not already have a chief risk officer, some firms will choose to designate a senior member of staff – for example, the chief operating officer, or the chief compliance officer – to act as the independent risk officer to ensure compliance. However, the Directive makes it clear that in order to be "functionally and hierarchically" independent, the designated staff member cannot be supervised by anyone responsible for portfolio management; nor can his or her compensation be directly linked to investment performance.

An alternative approach to complying with the Directive is for the firm to engage an external or 'outsourced' alternative fund manager or specialised risk management advisory firm to meet this obligation. By appointing a credible risk management advisory firm or senior level expert, regulators can be satisfied that there is independent risk oversight of the firm's investment strategy and portfolio.

"OF COURSE WE ALREADY DO SOME RISK MANAGEMENT…"

Many alternative investment managers will claim that they already do some risk management. However they may be underestimating the scope and formal nature of the risk policy and procedure requirements of AIFMD. The Directive requires managers to establish, implement and maintain formal risk management policies and procedures. This policy must explain who is responsible for risk management and describe what safeguards exist to secure the mandated independence for the function. It must describe the procedures used to assess all relevant market, credit, liquidity, counterparty and operational risks. It must identify all the material and relevant risks to which each of the firm's funds are exposed, set limits for each type of risk, and describe the tools and techniques used to identify, measure and monitors those risks. Back tests, stress test and scenario analysis must be performed. In other words, firms are required to implement a comprehensive set of policies and procedures governing risk.

Some hedge fund managers may already have some sort of policy in place or be measuring portfolio risks. However, they may wish to conduct a 'gap analysis' to check how far away they are from the wide ranging, detailed and repeatable risk management processes and procedures that are expected. For example, if a portfolio manager executes a trade outside his strategy mandate or authority, how is the violation identified? How is it remedied? What escalation procedures exist to make sure that senior management becomes aware of the problem? The Directive not only requires managers to document such processes, but requires reviews of their policies on a regular basis and to notify their national regulator of any material changes to their policies or their adopted measurement and management processes.

"…AND HAVE RISK LIMITS IN PLACE"

Alternative fund managers are required to establish and implement quantitative or qualitative risk limits for each fund they manage. Portfolio managers who already operate with some limits may be under the impression that those limits that they have subjectively chosen to apply are adequate for the needs of the Directive. AIFMD requires that a manger consider carefully all the principal risks – market, credit, liquidity, counterparty and operational risks – and customise limits to each fund based on its size, strategy and asset composition. Moreover, these limits cannot just be used for internal fund management; they must be justified to regulators and fully disclosed to investors.

Some managers who operate a UCITS compliant fund may believe that they understand how to operate a risk framework. However, a manager cannot mechanically adopt the UCITS limits to other strategies and funds if their structure and investment objectives are different.

A manager must also implement adequate risk management systems to identify, measure, manage and monitor all of these risks, and stress test the risks associated with investments at least annually. AIFMD places a special emphasis on liquidity and leverage management, a concern arising from the 2008 financial crisis. Managers must adopt policies to endure that liquidity risk is monitored, and that a fund's the liquidity profile is consistent with the investment strategy and the redemption terms offered to investors. If ever a fund violates its risk limits or its overall risk picture becomes inconsistent with its stated risk profile, the risk manager must report this in a timely manner to the fund's management and governing body.

"IF WE FILE FORM PF, CAN'T WE JUST COPY THE ANSWERS FOR ANNEX IV?"

AIFMD introduces a new portfolio risk transparency requirement in the form of the Annex IV form, which managers must submit to their regulators on a periodic basis. Like Form PF in the US, the regulatory goal of the Annex IV report is similar: to provide the regulators with a view of the potential systemic risks presented by the alternative investment industry. Both reports require managers to submit detailed risk profiles, describing the portfolio concentrations, liquidity and leverage of their funds. However, many of the questions and assumptions behind the questions in Form PF and Annex IV are substantively different, and therefore funds cannot assume that they can merely 'map the data' in one form to the other. Moreover, Annex IV requires managers to answer all questions. While Form allows managers to respond to certain questions by answering 'relevant but not tested', this is not an option under Annex IV.

"COMPLIANCE WITH THESE RISK MANAGEMENT REQUIREMENTS SEEMS ONEROUS..."

Compliance with the risk management requirements of AIFMD is a complex exercise involving governance, remuneration, policies, procedures, systems and reporting. Management of alternative investment firms should understand that compliance requires investment in time and resources, as well as significant subject matter expertise.

Managers should consider conducting a 'gap analysis' performed by a qualified and experienced risk management adviser to evaluate where they have gaps between their existing practices and the AIFMD requirements. They should develop a plan for not only implementing enhancements to fill gaps but also a plan for maintaining proper risk management processes, controls and governance. Managers should take a holistic and integrated approach to all risk-related regulatory and investor reporting versus the piecemeal approach often taken. Since AIFMD's requirements for risk management may become the standard for alternative investment managers everywhere, the Directive provides an opportunity for firms to build 'institutional quality' risk management infrastructure that not allows them to comply with regulation but meet increasing investor expectations for robust risk management and increased transparency.

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