## AIFMD AND RISK MANAGEMENT, A TRAGIC COMEDY IN 3 ACTS

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Most of us in the alternative investment world sighed with relief when the AIFM directive was voted and published last June. The European Parliament and Council had softened some of the content that had us throwing our arms in the air in protestation for the past two years. That was, however, only Act 1 of what we used to call a tragedy for the investment and asset management industry.

Luxembourg did not wait long to start identifying an adoption strategy and roadmap with the changes already introduced in the law of the 13 February 2007 relative to alternative investments. We have all now been thrown into Act 2. Six months down the road, with another (short) 6 months ahead to comply, the plot thickens. At least as far as risk management is concerned, we now know where to stand with Article 42bis. In three paragraphs, the text of law has set the scene. Specialized Investment Funds (SIF) now have to:

1. implement appropriate risk management systems to detect, measure, manage and follow up on risks associated with the investment position and in general with the portfolio risk;
2. structure and organize themselves so as to minimize the risk of conflicts of interest between the SIF and the people involved in its management directly or indirectly; and
3. be aware of the CSSF guidelines that will be published for compliance requirements regarding the points mentioned above.

Three paragraphs that at first sight seem quite innocent and reminiscent of the UCITS branded funds, but that open a world of difficulties for the industry players. The alternative investment industry as we know it in Luxembourg is a world apart, an environment where investors have to prove that they are educated and to that extent require a lower level of protection, where flexibility and the ability to react are key and are reflected in lighter regulatory requirements (stakeholders, ease of set up, fewer investment restrictions and lighter reporting). In short, an environment conducive to thinner management structures and therefore one that will need to adapt to comply with the requirements that are now being imposed.

The first paragraph creates management and cost pressure since, in so few words, it requires the funds and/or managers to develop and test a risk management framework. The goal is to monitor the alignment of the risk figures with the investment strategy. Not an easy task when the underlying assets are difficult to value and the risk exposures are difficult to classify. The population of SIFs being furthermore so diverse, this is far from a "cookie cutter" exercise. The hidden effect of such an exercise is the resource requirement: both that required to set up an independent risk management function and that required to manage risk on a day-to-day basis.

The second paragraph requires the managers and funds to re-structure themselves so as to minimize the potential risk of conflict of interest. This will require a full review of each and every management team, board and requesting financial and tenure information for each person of influence, a sort of "Know Your Managers" exercise that could generate additional cost should this be embedded in day-to-day processes. Additionally would clients be pleased to know that some data are "shared" with other market players for the purpose of "conflict of interest"? This is an environment where the real information about the target investment is only known at a late stage in the process and very often code names are used to protect the confidentiality. Therefore it will be difficult to reconcile the transparency requirement with the need for confidentiality.

With experience in UCITS branded funds and in view of the risk management requirements of UCITS IV, these core requirements could be addressed with a certain level of knowledge, if not of comfort. But this is without apprehending fully the mention that ultimately it is the role of the CSSF and its prerogative to define the application framework of the Article 42bis through its Circulars. If we take the level of detail published in the consultation of ESMA as a benchmark, we will face detailed regulatory requirements to implement by 30 June and later, so as to implement the AIFMD in its full risk management intention.

So the curtain has almost fallen on Act 2, but Act 3 is still to be written and the final denouncement will depend on how you, the key protagonists, address the change. While there are undoubtedly challenges to address and loose plot lines that have yet to be resolved, there is still scope for this tragic comedy to deliver a happy ending for the Luxembourg alternative investment community. In trying to align alternative investment regulations with the UCITS brand, the regulator has opened new doors to market SIF and hedge fund-like vehicles to a greater audience. A world of opportunities… So rather than approaching the AIFMD and SIF law compliance as a costly and valueless exercise, managers may wish to embrace the fact that it will allow them a greater understanding of their market, correlation between risk returns in their alternative products and most of all in the impact on their investor behaviours and profiles.