

AIFMD Impact on Service Providers

*Navigating the
Regulatory Maze*

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pwc

AIFMD – Impact on Service Providers

The Alternative Investment Fund Managers Directive (AIFMD) subjects managers of alternative investment funds (AIFs) to compulsory regulation in the EU and will require significant modifications to the structures, strategies and operations of fund managers and funds in the non-UCITS sphere and will also directly and materially affect those who service this industry.

The EU Parliament approved the AIFMD on 11 November 2010, and it is expected to come into force in April 2013. The Appendix sets out a timeline for the AIFMD implementation process and the role of the new European Securities and Markets Authority (ESMA).

AIFMD will require service providers to the industry (depositories, custodians, prime brokers, administrators, valuers and other outsourced service providers) to adapt to a very different market for alternative investment funds. AIFMD substantially redefines the relationships between fund managers, AIFs and their service providers and, as a result, service providers have a clear opportunity to enhance existing client relationships and attract new business by adapting their product offerings effectively to the new requirements.

AIFMD presents major operational, compliance and reporting challenges for fund managers. Depositary and (where used) prime brokerage arrangements will need to be realigned. Products and services will need to be designed to provide for a greater flow of information, either to allow a depository to perform its required functions under AIFMD or where administrators are asked to cope with the increased demand for reporting capacity by managers who now have reporting obligations to both regulators and investors. Valuation processes and procedures will require modification. Demand for third party assistance and assurance will almost inevitably increase as a result of AIFMD.

AIFMD is just one of a host of regulatory developments which service providers and their investment vehicles will have to adapt to over the next few years, including The Dodd-Frank Wall

Street Reform and Consumer Protection Act, FATCA, EMIR, MiFID II, UCITS V etc. While working to meet client needs, service providers must also address the impact that AIFMD and other regulatory changes will have on their own organisations' business, operational and compliance requirements.

To find practical, integrated solutions to the challenges posed by these multiple regulatory developments, service providers will need to consider their strategic positioning, undertake gap analyses to identify areas for change, and plan for implementation. Clients will expect service providers to understand the issues they are facing and support them through their own adaptation process by offering practical, economic solutions that are fully compliant with AIFMD requirements.

Service providers who react swiftly and effectively to the strategic opportunities offered by these developments can capitalise on the changing environment to gain competitive advantage by adjusting their business models and also modifying their product offerings.

Key areas for service providers

Service providers will face a number of challenges in adapting to AIFMD, particularly in areas such as:

- Depositary requirements
- Conflicts of interest
- Delegation and outsourcing
- Valuation processes and procedures
- Disclosure and reporting requirements
- Compliance function
- Grandfathering provisions, scope and authorisation requirements

We consider these issues below, identifying the practical actions that service providers will need to take to secure a market leading position when the full regulatory framework comes into force.

Depositary requirements

Currently, many AIFMs provide informal “custody” services to the AIF they manage or else rely on their prime brokers. However, going forward, all AIF will be required to appoint a single independent depositary to safeguard the fund’s assets. The depositary must be independent of the fund manager. For EU funds, the depositary has to be based in the fund’s Member State.

For non-EU funds, the depositary can be an EU credit institution or a credit institution or an investment firm from the fund’s domicile or the manager’s home Member State (if EU domiciled), or its Member State of reference (if offshore). If a non-EU depositary is used, it must be subject to effective prudential regulation and supervision having the same effect as EU laws and which are effectively enforced. Regulatory cooperation agreements and tax information exchange agreements will also need to be in place between the third country and each Member State where the fund is marketed, and the country must not be on the FATF list of non-cooperative countries. The third country depositary will have to be contractually liable to the fund or its investors.

Although generally funds will be required to appoint a depositary which is a credit institution or similar entity, Member States will be able to permit closed-ended EU AIF which do not provide redemption rights in the first five years and generally invest in issuers or non-listed companies to acquire control, to appoint other persons who carry out depositary activities as part of their professional activities, such as law firms, notaries or other authorised investment firms. As a result, depositaries may face a diverse range of new competition in this market segment.

AIFMD contains extensive provisions on the depositary’s role and responsibilities, its ability to delegate and its liability to the fund and investors. The harsher strict liability provisions previously proposed have been modified and there is now potential scope to avoid some of the more onerous local depositary requirements where no local depositary satisfying the relevant criteria is available. That said, to take advantage of this provision, fund managers need to demonstrate that the local depositary can still satisfy certain fit for purpose and quality criteria.

Service providers will need to ensure they have the resources (people and systems) to meet the AIFMD’s

requirements, and proactively demonstrate their preparedness to clients. Contractual arrangements will need to be revised to reflect the new regime and ensure appropriate information flows. Service providers should begin by undertaking a gap analysis to evaluate the impact on their business model, operations, product offerings and pricing, to work out what is done by whom, for whom and in what business area, in order to start evaluating what changes may need to be made, both in response to obligations imposed directly on them and to respond to client driven demand.

Conflicts of interest

Under AIFMD fund managers must identify conflicts of interest arising in relation to the AIF they manage, and put in place effective organisational and administrative arrangements to prevent, manage, monitor and disclose conflicts of interest, to protect AIF and their investors. These requirements have significant implications for the way in which functions are delegated to service providers, and the contracts reflecting these arrangements. In addition, certain services which have traditionally been provided by third parties have to be provided by entities that are mutually independent, so, for example, providing valuation, prime brokerage and fiduciary services all under one roof may be complicated.

Practically, this means:

- AIFMs must ensure that each AIF they manage has a single depositary, which is independent of the AIF and the AIFM. The depositary must act independently and solely in the interest of the AIF and its investors.
- A prime broker acting as counterparty to an AIF is not allowed to act as a depositary for that AIF, unless it has functionally and hierarchically separated its depositary functions from its tasks as prime broker and any potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors in the AIF.
- The depositary can only carry out custody tasks and provide prime brokerage services if it has established functionally and hierarchical separation of these two functions.

- The valuation function may be performed either by an external valuer or by the AIFM, provided it is independent of the portfolio management function for the AIF and persons administering the remuneration policy of the AIFM, to ensure conflicts of interest and undue influence upon the employees of the AIFM are prevented.
- If an external valuer is used, that valuer cannot have close links to either the AIF or AIFM and will have uncapped liability for its valuation work. In addition to the “close links” prohibition, the depositary of an AIF cannot be appointed as its external valuer, unless the depositary has functionally and hierarchically separated the performance of the depositary functions from the valuation function, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF’s investors.

Delegation and outsourcing

AIFMD’s delegation provisions will alter the fundamentals of the contractual relationships between AIF and their investors, fund managers and service providers, and require changes to the operational arrangements supporting AIF:

- Fund managers will continue to be able to delegate functions (including portfolio management and risk management) subject to giving advance notice to their regulator. They must be able to objectively justify the entire delegation structure, and will have to review the services provided by each delegate on an ongoing basis.
- Delegates taking on portfolio or risk management responsibilities will have to themselves be authorised asset managers which are subject to regulatory supervision (unless the fund manager’s regulator agrees otherwise).
- Where the delegate is based in a third country, regulatory cooperation agreements must be in place. The delegation must not prevent effective supervision by or of the fund manager or prevent the fund manager from acting or the fund being managed in investors’ best interests. Also the fund manager must retain the ability to adequately

monitor the delegate’s performance and terminate the delegation if necessary.

- Sub-delegation is permitted, subject to the conditions above and manager consent.
- Managers cannot be a mere letter-box (precisely what this means is to be defined in the Level 2 implementing measures). They will have to be able to demonstrate that delegating the relevant functions is in the best interests of investors, that their selected service provider is appropriately qualified and experienced, and that they retain the ability to monitor the provider and give instructions, and to withdraw the mandate immediately if necessary to protect investors.
- The manager’s liability to the fund and its investors will remain unaffected by any delegation (or sub-delegation) of its functions.

Existing contractual arrangements including sub-management, administration, advisory and other outsourcing agreements will need to be updated to reflect the new regime.

Valuation processes and procedures

Valuation related services represent another potential growth area for service providers, as clients may need additional assistance to comply with the detailed requirements on valuation processes and procedures under AIFMD. Each fund’s assets will have to be valued and the NAV will be calculated at least on an annual basis. Open-ended funds will be required to carry out more frequent valuations and NAV calculations at a frequency appropriate to the assets they hold, whereas closed-ended funds have to carry them out each time the capital of the fund increases or decreases. More details on valuation requirements will come in the Level 2 implementing measures.

Increased liability exposure is a particular area of concern with valuations under AIFMD, as service providers will no longer be able to cap their liability to the fund manager. However, precision in defining roles and responsibilities in the valuation area may render this possible liability more manageable.

Many alternative fund managers have traditionally carried out valuation activities themselves, and will be able to continue to do so under AIFMD but

regulators will be able to require that an external valuer or auditor verifies the internal valuation. However, they will be required to ensure and demonstrate that valuation functions are independent from the portfolio management function and the persons responsible for implementing the firm's remuneration policy. Some fund managers may simply not have the personnel or organisational structure to permit them to do this; others may choose to outsource as a more convenient and cost effective option. In addition, as a result of AIFMD, we believe investors will be more inclined to require AIF to have external valuations.

Service providers will need to revisit their pricing for valuation services, and factor this and their increased liability exposure into their business models and product offerings. Fund managers and service providers will need to agree revised valuation processes and procedures to comply with AIFMD. Systems may require updating, and fund documentation and service provider contracts will need to be updated to reflect the new requirements. This is another area where clients may need assistance and will expect service providers to be fully aware of requirements and able to offer solutions.

Disclosure and reporting requirements

Service providers will find that clients need more assistance with AIFMD's extensive disclosure and reporting requirements. Service providers will be asked to provide assurance that the reporting they provide is fully compliant with the level of detail expected, and that their systems are able to produce the required data. The compliance and legal departments of a service provider will need to ensure that all contractual arrangements are appropriate in case the data provided is deemed to be insufficient by the regulator.

Service providers will want to consider further opportunities around assisting fund managers with reporting to investors. Managers will have an obligation to make full disclosure to investors (before they invest) including a description of the investment strategy and objectives of the AIF, the types of assets which the AIF may invest in, techniques it may employ, and procedures to be used to alter the investment strategy. In addition, they will have extensive ongoing reporting requirements to investors.

AIFMs will also be required to make extensive disclosures to regulators in areas such as gearing, liquidity, risk management, trading activity, and for PE managers, information about portfolio investments. In practice, this means a report on the principal markets and instruments traded on behalf of an AIF and an annual report for each AIF. The competent authority may request a detailed quarterly list of all AIF an AIFM manages. In addition, further ad-hoc reporting may be required if necessary for effective monitoring of systematic risk.

Many fund managers simply will not have the capacity to do all this in-house, and will need assistance with planning around the presentation of information as well as reporting services to cope with these increased disclosure requirements.

Compliance function

AIFMD will force service providers and fund managers to review their compliance functions, particularly in relation to the way conflicts of interest and risk management are handled. Service providers themselves are likely to require more compliance resources to cope with the burden of ensuring compliance with AIFMD.

Grandfathering provisions, scope and authorisation requirements

Managers with aggregate assets under management (AuM) of less than €100m leveraged or €500m unleveraged will be subject to a lighter touch registration and reporting regime. Existing managers and their funds have until April 2014 to comply fully with AIFMD.

AIFMD offers only limited grandfathering provisions, which will not benefit most existing funds:

- Managers who have only closed-ended funds that do not make any further investments after April 2013 will not be required to become authorised under AIFMD - it is not clear how add-on investments affect this exclusion.
- Likewise, managers with only closed-ended funds where the subscription period ends before April 2011 and which will terminate by 2016 are not required to become authorised.

Many funds will not be able to take advantage of these very limited grandfathering provisions, and will

have to be adapted to comply with the new regime. Fund managers will need support from their service providers to accomplish this transition.

What questions should we be considering in preparation for AIFMD?

Service providers need to consider a number of issues now:

- Does this represent an opportunity to get ahead of the curve?
- What will the organisation need to do to comply/excel?
- What is the current state of preparedness?
- If the firm adapts its existing business model to comply with AIFMD, what are the implications for our product offerings, client services and pricing?
- How should the firm respond in an appropriate way to the competition?
- Is the firm doing business and offering our products and services in the right locations?
- Are the firm's existing clients affected by AIFMD and if so, what adaptations need to be made to existing procedures, fund documentation and service agreements?
- What will the impact on the firm's resources and systems be?
- How will the firm's compliance function need to adapt?

How can PwC help?

Working with us, you will have access to the industry knowledge accumulated across our leading asset management practice, together with recognised experts in strategy, law and regulation, capital requirements, compliance, tax, remuneration, valuation, operations and structuring.

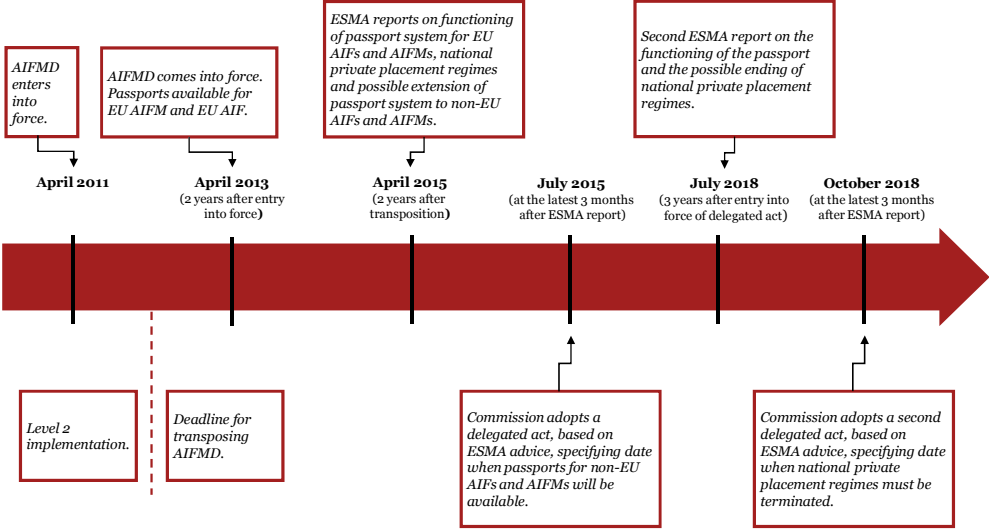
Our collaborative methodology will be used to establish a framework for your AIFMD service solution, tailored to your business requirements, by helping you shape your service offering to clients:

- completing impact assessments

- setting objectives and planning for implementation
- designing and constructing solutions
- implementing agreed actions
- ensuring effective operation, validation and ongoing review

By working with you through the AIFMD analysis, we can help you manage its potential cost and resource requirements, to best exploit the opportunities presented by the new regulatory environment.

Annex I: Timeline



Annex II: PwC Contacts

If you would like to discuss any of the areas covered in this paper as well as the implications for your business, please speak with your local PricewaterhouseCoopers contact.

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