

The steps needed to capitalise on AIFMD for Ireland

With the Alternative Investments Fund Management Directive due to come into effect in April 2013 DERVLA MCCORMACK looks at what fund administrators and custodians should do to capitalise on the new opportunities the directive is creating.

A recent report has revealed that the proportion of the world's hedge funds domiciled in Ireland doubled by the end of the third quarter of 2010 from the end of 2009, establishing Ireland as the third most popular hedge fund domicile globally. As the industry moves towards increased transparency and regulation and with the AIFMD expected into force in April 2013, Ireland is in a prime position to attract new and on-shoring alternative fund managers from across the globe. In evidence of Ireland's success to date, total assets of Qualifying Investor Funds (QIFs) grew by 35 per cent during 2010 to €153 billion. This AIFMD compliant product has the advantage of offering alternative fund managers and



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providers really stopped to think about how this critical advantage can be capitalised upon in the AIFMD context? For a prospective alternative fund manager considering Ireland as a potential domicile for their fund or fund administration, they will expect service providers to offer a level of end-to-end preparedness, and expertise in the operational and regulatory requirements of the AIFMD which will effectively allow them to 'plug and play' and get on with the business of investment management and marketing the fund.

As the Level II text emerges, service providers will need to get up to speed quickly and prepare strategic plans which capture opportunities and threats, and quantify the required investment, considering 'first to market' advantages as well as the benefits that will accrue to those that can deliver a slick all-encompassing range of AIFMD compliant services.

Re-positioning the depositary offering

The Directive requires a fund to appoint an independent depositary to perform certain supervisory duties and safe keep the investments of the fund. This is over and above what is currently provided by most prime brokers and so this presents an opportunity for Irish depositaries to adapt their product offerings so as to target alternative fund managers who currently do not use a custodian. The liability regime will however be a key consideration for depositaries considering this route.

Under AIFMD, there will be new depositary responsibilities to be considered, i.e. monitoring cash flows and ensuring that all subscription payments have been received and all cash booked in relevant cash accounts.

The Directive differentiates between financial instruments that can be held in custody and other assets. For non custody assets such as OTC, Private Equity and Real Estate, the depositary must verify the ownership of and maintain a record of

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such assets. This is something which depositaries are already doing under Irish non UCITS legislation. However, the AIFMD Level II text will specifically address the mechanism by which this verification might be achieved and will require more rigorous procedures and more information from the AIFM and third party sources.

The Directive is already more prescriptive than the Non UCITS notices in terms of the core duties of the depositary. It can largely be expected that the depositary will be required to exercise more control, perform more frequent as well as more independent verification and monitoring of activities carried out by the fund administrators, custodians or transfer agents. All depositary functions will become more specialised, given the increased complexity of the products, funds and relationships involved. Investment restrictions monitoring, oversight of NAV calculation and verification of asset existence for example, will now require a greater expertise to address the complexity and the increased level of risk involved in performing the depositary role under AIFMD. Depositaries will therefore need

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investors the flexibility of typical hedge fund products but in a regulated vehicle.

As an established alternatives centre, the Irish regulatory regime and supporting service provider framework is already well placed to meet AIFMD requirements, such as those pertaining to the depositary/custodian, fund administrator/valuer as well disclosure and reporting requirements. All Irish funds, both UCITS and non UCITS, are already required to have a trustee/depositary and are administered and valued by entities authorised and supervised by the Central Bank of Ireland.

Ireland has always attracted investment on the back of its flexible regulatory environment, tax benefits, industry expertise, and perhaps most importantly, its ability to provide a 'one stop shop' service range including best in class custody, administration, legal, audit and advisory services. But have service

to invest heavily in processes, controls, resources and expertise.

Custody and safe keeping duties may be delegated to custodians and prime brokers provided a number of criteria are satisfied. Under AIFMD, the depositary is required to accept far greater liability than before, i.e. in the event of the loss of assets, including where the safe keeping duty has been delegated. The liability is shifted to the depositary thereby protecting the fund and investor in the event of a loss. It can be expected that as a result of the liability provisions, some depositaries may in the future, withdraw from certain markets or be more selective, and cautious about entering unfamiliar markets.

The depositary will not be deemed liable where it can prove a loss was due to an external event beyond its control. In certain cases, the depositary can also discharge itself of liability by sub-delegation but there must be a written

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contract between the depositary and the third party that explicitly transfers the liability. In reality however, it remains to be seen whether such third parties who already operate on slim margins would sign a written contract accepting such liability and how such arrangements would be managed, legally and operationally.

Overall, depositary costs can be expected to rise substantially due to the required investment in resources and processes and where substantial insurance premiums need to be paid to protect against losses of financial instruments. The extent to which these costs can be passed down to funds and investors remains to be seen, but it is likely the environment will favour larger depositaries who can leverage scale to address increased costs. Depositaries will need to strategically assess their cost structures and fee models in order to remain competitive. Some will withdraw from the industry and M&A activity is expected to increase. The liability regime imposed by the AIFMD could ultimately contribute to a substantial increase in systemic risk where the viability of depositaries is threatened by the scale of

its potential liabilities, and the number of depositaries available to funds which are willing to accept these new terms of business will reduce, thereby reducing competition and increasing concentration risk.

Depositaries will need to revisit existing contracts in relation to delegation and sub-custody arrangements to identify where liability issues arise and to ensure AIFMD compliance. For example, in Ireland, a sub custody agreement is always in place between the depositary and an appointed prime broker. This model has, to date not typically existed in other jurisdictions where the agreement is between the fund and the prime broker only. Different jurisdictions therefore, will have different starting points in terms of getting the required third party agreements in place.

As AIFMD implementation looms, depositaries may need to consider new sources of competition and respond by extending into new service areas. A prime broker acting as counterparty to the fund may act as depositary if it has separated its prime broker and depositary functions and conflicts of interests are addressed. Prime brokers are already re-organizing their operating models in order to capitalize on this opportunity. Ireland does not have a tradition in prime brokerage, but depositaries may in turn need to extend into the realm of prime brokerage, while ensuring the required separation of functions is in place and conflicts are addressed. For the smaller players, such a re-positioning would be challenging. Otherwise, depositaries may need to consider their relationships with external prime brokers with a view to increased collaboration in order to deliver a seamless offering to alternative fund manager clients. Prime brokers should position themselves to service this new client base, including enhancing their knowledge of local regulations and depositary operations.

Strategic advantages may accrue to those hedge fund administrators who have a depositary / custody arm, and those who do not will, in the future need to engage not just with prime brokers but with a depositary / custodian (or prime broker performing these functions in a segregated manner) and again, those administrators who can collaborate effectively to present a streamlined offering will be well positioned.

Transparency and reporting

AIFMD presents compliance and reporting challenges for alternatives fund managers, requiring ongoing disclosure to

regulators and shareholders as well as to potential investors. Service providers such as fund administrators have access to much of the relevant information and will be asked to provide this transparency reporting in an appropriate format, to the required level of detail in an efficient

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manner, and in some cases to provide assurance as to the accuracy of the data provided or coming from their systems.

To be or not to be an AIFMD valuer

The Directive requires the manager to appoint an independent valuer to the fund. This development is going to fundamentally change the role of the fund administrator, who will most likely be expected to perform this role. Irish administrators have a critical advantage in having extensive experience in the processing and valuation of alternative investments, and in response to investor pressure, many are currently providing 'independent' valuation of the type specified by the AIFMD. This may to some extent satisfy the requirements of the AIFMD, however there is a strong possibility that more sophisticated products are not adequately catered for by existing processes.

Administrators may well end up with unlimited liability in relation to valuation, which seems to include NAV calculation in the Level I text, i.e. in the case of pricing or NAV errors. The manager may perform the valuer role in-house where appropriately segregated from the trading function, but it is unclear whether the manager could perform the valuation function itself but still outsource the NAV calculation function to the administrator i.e. the manager would accept ultimate responsibility and therefore liability but the administrator would gather the price information and calculate the NAV. However, even if this model becomes a possibility, it seems unlikely that it would meet the expectations of ever-vigilant investors.

Taking the broader definition of the valuer role and assuming an administrator performs this role, the question remains as to how an administrator can accept



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responsibility for valuing esoteric assets that might previously have been valued by the manager or an industry specialist. The restrictions on delegation of the valuer role may also be a challenge for those administrators whose operating models include cross border internal or external delegation of NAV calculation or pricing functions.

Administrators choosing to perform the role will inevitably need to invest in technology, resources and enhanced validation procedures, all the while considering the costs associated with the liability regime. As in the case of the depository, the extent to which costs can be passed on remains to be seen, but given the level of competition in the fund administration industry currently, managers will be in a strong position to negotiate a favourable service package.

Relationships

AIFMD will redefine the relationships between fund managers, funds and their service providers and, as a result, service providers have an opportunity to achieve competitive advantage by carefully managing operating models, relationships and building new collaborative arrangements where required. Services which have traditionally been provided by a single third party now have to be provided by entities that are independent of each other, so providing valuation, prime brokerage and depository services under one roof while not impossible, will need to be carefully managed and strategic planning will be key.

The Directive will bring both opportunities and threats. The key challenge for Ireland and for service providers will be in positioning the country as the domicile of choice in terms of the quality and range of AIFMD compliant services available. This will of course extend into other service areas such as the legal, audit, tax and advisory services to meet these clients' requirements. Service providers need to think strategically about the key considerations should they opt to service this client base or the consequences if they choose not to. Planning is essential.

Next steps

Depositories and fund administrators will need to strategically assess whether they are prepared to offer these services, and to reassess the fee levels under which they will do so, in light of the proposed liability regimes, the required investment, as well as the impact of not providing these services if the competition does.

The depository cannot be the valuer unless conflicts are managed and segregated functions are in place. In addition, the valuer role (which currently includes pricing and NAV calculation) cannot be delegated. Administrators wishing to provide AIFMD compliant services will need to carefully review their operating models to ensure an appropriate level of segregation is in place and delegated functions meet AIFMD criteria.

Depositories and fund administrators will need to re-assess their strategies and operating models, expanding into new

service areas or establishing new relationships where required. Depositories will need to establish relationships with new custodians and prime brokers in order to achieve the scale needed to cover all

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relevant markets while managing the risks attached to such markets.

Depositories will need to review legal contracts and agreements in relation to delegation and sub-custody arrangements to identify where liability considerations arise and to ensure agreements are appropriately structured.

Depositories and fund administrators will need to assess the required investment in enhanced technology, processes, controls, expertise and resources and how fee models will need to be adapted to reflect the extended service offering.

Fund administrators will need to assess the required investment in information and reporting systems to provide the required compliance reporting in an efficient manner. They should also consider how they will deliver assurance to managers, regulators and investors as to the accuracy and quality of system generated data.

Fund administrators and depositories should keep close to existing clients and seek to understand expectations of potential and re-domiciling clients, in particular those who are less familiar with AIFMD and European regulation. Will an ability to provide any / all of these services in a 'one stop shop' model be critical to retaining clients and to the success of an RFP?

The terms of the AIFMD will be rules based with specific implementation measures. Service providers should be guided by the Level II measures for strategic positioning. April 2013 may seem a long way off but in the meantime, alternatives managers looking to Ireland will consider the level of AIFMD preparedness as a key consideration for setting up or having a fund administered here.

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