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AIFMD changes Europe's €2trn alternative investment fund industry

Transparency and investor protection - how the AIFMD impacts the AIFM, its service providers and the AIF depositary

In the wake of the financial crisis and the Madoff fraud, The European Alternative Investment Fund Managers Directive (the "AIFMD") introduces sweeping changes to how alternative investment funds are managed and sold to European investors. Alternative investment fund managers (referenced under the AIFMD as "AIFMs") will be subjected to harmonised rules, regardless of the fund types they manage. The new legislation effectively divides EU investment funds into two categories; UCTIS funds and alternative funds. In addition to establishing this simple categorisation, the directive also aligns the requirements for managing alternative funds to those for managing UCTIS funds. This has significant implications for the alternative investment fund managers, their service providers, the funds themselves and their depositaries.

Topics in this paper

- The directive
- Impacts on the fund value chain
- The deepening manager - service provider relationship
- Increased depositary duties and liabilities
- New hedge fund - prime broker - depositary models
- Conclusion

The directive

The AIFM Directive introduces harmonised rules for managers (AIFMs) of alternative investment funds (referred to under the AIFMD as "AIFs") that are sold to EU investors. The Madoff fraud, the Lehman experience (impacting hedge funds) and the political desire to create more transparency around hedge funds and private equity funds were immediate catalysts for this new directive.

The Madoff fraud highlighted varying levels of investor protection across EU member states. The main differences lay in the definition of circumstances in which investors could expect to have their assets restored to them, if they were lost. The directive introduces tough common asset restitution liabilities on EU fund depositaries to address this issue.

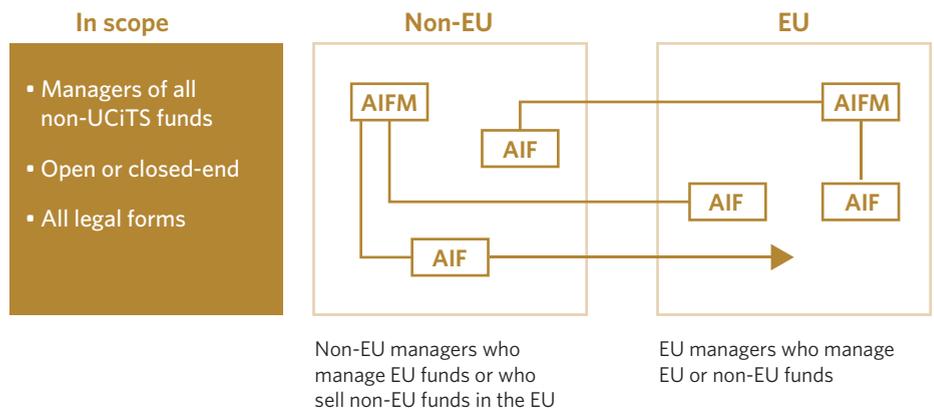


The second overarching objective of the directive is to create more transparency. Transparency is a common objective across many recent regulations. Greater transparency is expected to result in more effective supervision, better mitigation of systemic risks, greater accountability, and more effective allocation of capital. An example of a transparency measure is the creation of a central public register identifying each AIFM authorised under the directive and a list of the AIFs that those managers manage, or market in the EU.

AIFMD covers all types of alternative investment fund managers, including those who manage hedge funds, private equity funds, real estate funds, commodities and infrastructure funds. The scope is not limited by any regard to investment strategy or legal structure. Large categories of investment funds across Europe, which have traditional rather than alternative investment strategies, also fall within the scope of the directives. These groups of investment funds include, amongst others, German Spezialfonds and closed ended funds, UK Investment Trusts and a many funds in The Netherlands.

The extraterritorial scope of the directive becomes apparent in view of the criterion that includes any manager of a fund that is made available for investment to EU investors. This definition includes, for example, both a UK manager who manages a Cayman-domiciled hedge fund and a Japanese manager who manages a Luxembourg-domiciled SIF.

FIG. 1: AIFMD SCOPE



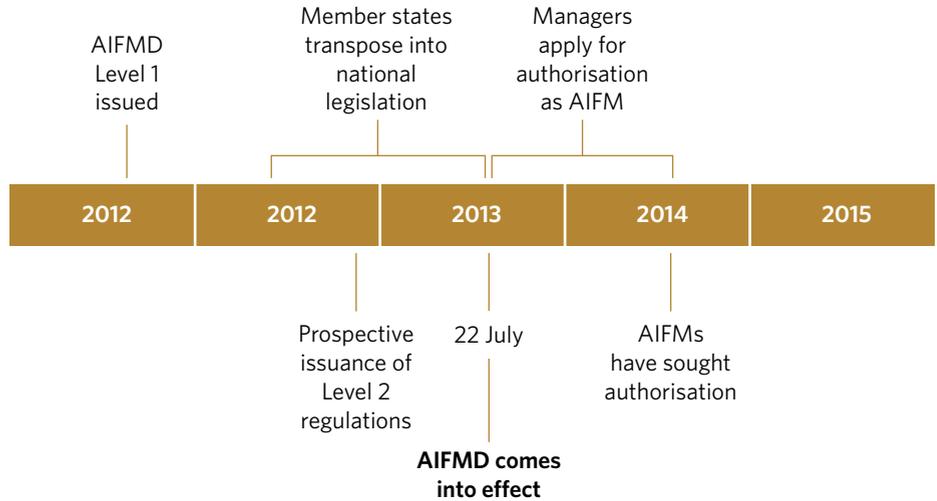
European investment funds are either regulated as UCITS funds, under the UCITS directive, or as AIFs under the AIFMD. Investors hold approximately \$6trn of UCITS assets and \$2trn of AIF assets. Whilst UCITS funds are authorised for sale to retail investors, AIFs are, in principle, aimed at professional investors. UCITS funds are widely considered to provide a high degree of investor protection. This perception has contributed to the emergence of the UCITS brand and the success of the UCITS vehicle far beyond the EU's borders. Nevertheless, the AIFMD will introduce investor protection standards for AIFs that are higher than those currently in effect for UCITS vehicles. This will create an unintended anomaly, where professional investors buying into AIFs are better protected than those investing into UCITS vehicles. UCITS V will correct this anomaly and introduce equivalent depositary requirements for AIFs and UCITS vehicles.

Level 1 of the directive was published in July 2011. This level of the legislation must be transposed into EU member states' legislations by 22 July 2013. Germany, Luxembourg and The Netherlands have been the first to publish draft local laws. The approach has been slightly different in each country. In Germany, for example, the legislator has largely rewritten the law into the new KAG-B. Luxembourg, in contrast, has taken the "loi chapeau" approach and implemented an umbrella form

of legislation to apply over and above current relevant fund laws. The UK financial regulator may rewrite large parts of the COLL into a new FUNDS handbook. Overall we might see a gradual and often delayed adoption by member states, analogous to the UCITS IV adoption pattern.

The more detailed AIFMD legislation, Level 2, clarifies particular aspects of the Level 1 directive. Level 2 takes the form of a regulation and is directly applicable at a national level. EU regulations eliminate national divergence in their application and are therefore a strong tool for harmonisation across member states.

FIG. 2: AIFMD TIMELINE



Considering the effort required by all value chain participants to become compliant, the time between the prospective issuance of Level 2 regulations and AIFMD coming into effect is very short. Although managers have 12 months from 22 July 2013 to apply for an authorisation as an AIFM, the industry as a whole has to be careful not to push out the compliance efforts until the end of the period as this could create bottlenecks.

In addition to defining its own scope, the AIFMD explains the authorisation process the manager has to go through, the conditions under which it must operate as well as its reporting requirements.

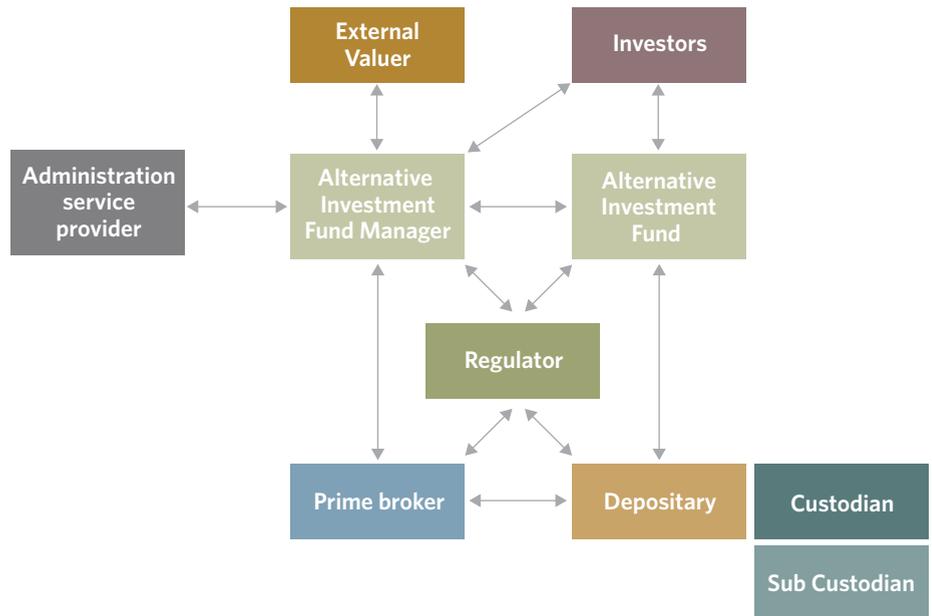
FIG. 3: AIFMD STRUCTURE

Scope		Authorisation				Operating conditions				Transparency requirements			Additional provisions						
In scope	Exemptions	Conditions	Application	Capital	Remuneration	General requirements			Organisational requirements & valuation	Delegation	Depository	Annual report	Disclosure to investors	Regulatory reporting	Specific AIF managers	Passporting	3rd country rules	Marketing to retail investors	Transitional provisions
						Conflicts of interest	Risk management	Liquidity management											

Impacts on the fund value chain

AIFMD impact all actors in the fund value chain, whether supervisory authority, investor, manager, depositary or service provider. However, the directive is primarily aimed at describing the manager's duties and obligations and does this taking into account to the context in which the manager operates.

FIG.4: THE FUND VALUE CHAIN



All parties in the value chain have their particular role:

- The **alternative investment fund manager's** objective is to provide the investors with investment returns as per the objectives of the fund. Portfolio management and risk management are designated responsibilities of the AIFM, and the manager will need to carry out these functions whilst adhering to the operating conditions detailed in the directive.
- The fund manager may appoint an **external valuer** to value some or all of its assets. The manager may also choose to perform the valuation itself, provided that the valuation function is functionally and hierarchically separate from the portfolio management function. The objective is to prevent the portfolio manager from valuing the investments he has made.
- The manager may delegate activities to the **administration service provider**. These may, for example, include fund accounting, transparency reporting, liquidity monitoring, transfer agency, collateral administration and risks and compliance reporting services. These services support the manager's efforts for continued compliance.
- The depositary maintains a delegated supervisory role. It provides oversight and control over the fund's activities as well as protection and safety for investors' assets. The depositary and custodian also maintains a chain of sub-custodians to enable the fund to invest in assets across the globe.
- For hedge funds, the **prime broker** may continue to provide financing. A key change introduced by AIFMD is the requirement for the AIF only to appoint one depositary for all of its assets. Going forward, the prime broker can therefore only service the fund's assets as a delegate of the depositary.

All parties in the fund value chain will have to explore new operating models and determine which ones will achieve the highest level of investor protection whilst containing the impact on investment returns as costs to serve go up.

The deepening manager – service provider relationship

Alternative Investment Fund Manager coming within scope of the directive¹ face a long list of organisational and transparency requirements that they must fulfil. These include valuation requirements, transparency reporting requirements risk and compliance requirements.

The manager must think strategically about how these requirements can be met. The considerations range from organisational design to delegation arrangements and data architectures.

The organisational design is critical to avoid conflicts of interest and is essential to meet the requirement for functionally and hierarchically independent risk management and valuation functions. Delegation can play an important role in achieving these objectives.

Also very significant are the transparency reporting obligations to investors and supervisory authorities. The EU Commission's impact assessment acknowledges that managers will incur additional costs when complying. The administration service provider can help support the manager's compliance as it is already a main repository of fund data. The transparency reporting is split into three major categories: annual reporting, investor reporting and regulatory reporting.

- Annual reports draw their quantitative components from fund accounting and are, for some fund types, not materially different from existing requirements.
- The investor reporting requirements include information that may be common to some current fund offering documents - although special consideration should be brought to the required leverage calculations.
- The reports required by the regulators follow a lengthy form which must draw on multiple data sources, including fund accounting and risk management data.

Drawing the required information together from multiple sources and repurposing it for reporting and management purposes is a significant task. A thorough consideration of the overall data architecture and the delegation arrangements may lower the risk and cost of the envisaged solution. Together, the alternative investment fund manager and its service provider can devise effective strategies for compliance.

Increased depositary duties and liabilities

One of the key outcomes of the AIFMD should be a standardisation of depositary duties and liabilities across the EU. This should offer investors greater choice of funds as they know they will enjoy a common standard of oversight, safe-keeping and liabilities regardless of the domicile of the fund. The depositary must, in order to fulfil its duties and responsibilities under AIFMD, fundamentally revise its oversight processes and the infrastructure it uses to support that process. Many alternative investment funds have to date not required a depositary and for the managers of these funds the interaction with the depositary is new.

The depositary duties and responsibilities include:

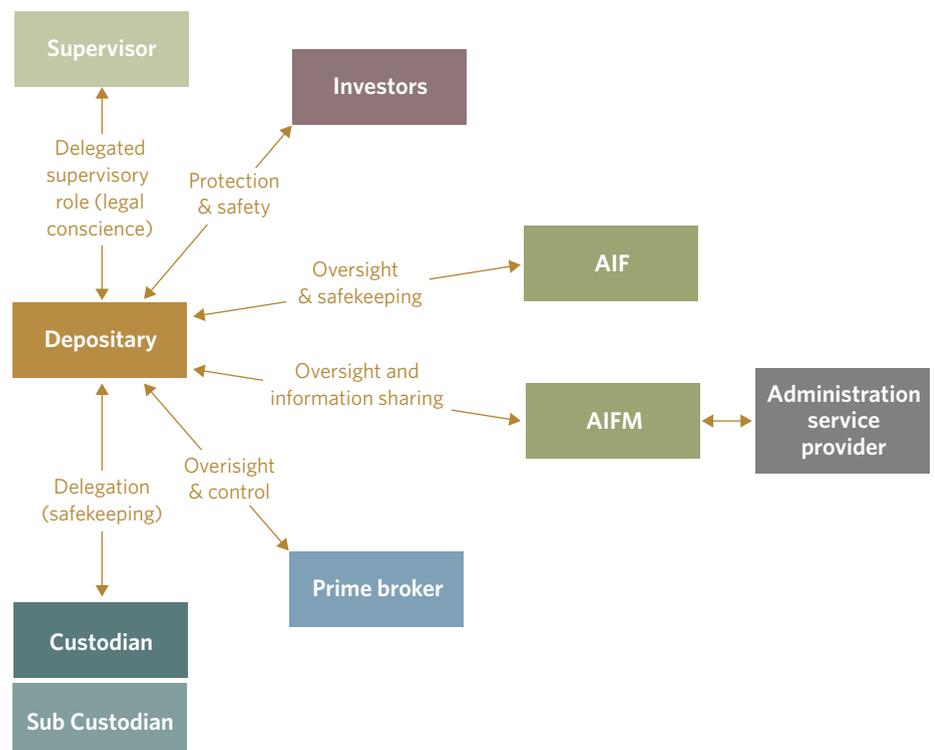
- Entering into a contract with AIF that describes the obligations of the depositary as well as the AIFM, including information sharing and escalation procedures.

¹ To operate in the EU, all AIFM with assets under management ("AUM") exceeding €100 million (or €500 million for closed ended unleveraged funds) must obtain initial authorisation from their member state regulators by providing information on themselves and their AIFs. AIFMs whose AUM do not reach these thresholds may opt in to the full regime.

- Cash monitoring. The depositary must ensure the all subscription monies are received and that all the AIF's cash is booked in cash accounts that the depositary can monitor and reconcile.
- Safe-keeping of assets that can be held in custody (referred to as "held-in-custody financial instruments"), which include assets such as physical and book-entry securities. The depositary is liable for the restitution of these kinds of assets.
- Record-keeping of assets not held in custody. The depositary must verify the AIF's ownership of these assets.
- Oversight duties. These duties extend to verification that subscriptions and redemptions have been processed correctly, that AIF's and AIFM's procedures have been applied, that the fund and its manager acts in accordance with laws and regulations, and that transactions are settled in a timely manner.
- Delegation and segregation of assets held-in-custody financial instruments. The depositary must ensure that these assets are segregated at the level of the sub-custodian and that the delegation of safe-keeping is overseen with the appropriate due diligence.

These duties add up to a significant programme of work that the depositary must undertake for each fund it oversees. Every area of responsibility has its own set of implications. For example, the EU Commission foresees that the depositary becomes a central hub where all information related to the AIF's cash flows is centralised, recorded and reconciled. This may imply that the depositary must record cash transactions in a position keeping system. Apart from the considerable operational effort and technology infrastructure required to fulfil this requirement, the cash monitoring requirement also puts additional focus on the depositary contract as the AIFM and all third party entities must send all cash account information to the depositary, without undue delay.

FIG.3: AIFMD INTRODUCES A PIVOTAL ROLE FOR THE DEPOSITARY



Groups with depositary entities in multiple EU jurisdictions are well placed and have an opportunity to harmonise and build on their current capabilities to service funds under AIFMD. An exhaustive analysis should be undertaken to compare every function currently performed in each jurisdiction, including the tools supporting the function, the associated volumes and the complexity. This as-is analysis can serve as a baseline for the gap analysis against the AIFMD technical standards. The gap analysis would show what tools and controls need to be developed to ensure compliance. As AIMD has largely harmonised the depositary requirements across jurisdictions, the group depositary can equally harmonise its processes and reduce procedures across the jurisdictions in which it is active. This should lead to more efficiency and somewhat the overall increase to the cost of providing depositary services.

The safe-keeping of assets held in custody is associated with a special risk for the depositary – the restitution liability. The depositary must return an asset, or its equivalent value, to the fund, if the asset is lost. The scope of the definition of assets that can be held in custody has therefore become a key aspect of the AIFMD implementation debate. The implication for the depositary is that it must further mitigate the risk of an eventual loss. This might be partially achieved by tightening the contractual terms with sub-custodians and the on-going due diligence programmes undertaken over them as well as the markets in which they operate. However, the additional costs of these initiatives have diminishing returns. It is practically only fraud and error, coupled with insolvency at the level of the sub-custodian that might lead to a loss of assets. The depositary must insure itself against these losses by increasing the capital it holds against such a loss event. The cost of this capital is a real cost of investor protection and the depositary will expect to recoup that cost to protect its margin.

New hedge fund - prime broker – depositary models

It is currently common for prime brokers to hold hedge fund's assets in their own global custody network. Under AIFMD, the AIF has to appoint a depositary that holds all the fund's assets. This means that a continuation of pre-AIFMD models can only be continued if the requirements of delegation of safe-keeping by the depositary to a third party are met.

There are several hurdles to overcome before such a delegation could take place. The prime broker must demonstrate that it has functionally and hierarchically separated the performance of its safe-keeping functions from its tasks as a prime broker. And, the prime broker's potential conflicts of interest must be properly identified, managed, monitored and disclosed to the investors of the AIF. However, the depositary will be reluctant to appoint a prime broker as sub-custodian as the assets for which the depositary is liable for restitution would sit outside its own network and immediate control.

In all cases, the AIF or AIFM must inform the depositary of the contracts it has entered into with prime brokers. The fund manager must also inform the depositary about the due diligence performed in the selection and appointment of prime brokers. The prime brokers will, in turn, be required to make detailed information available to the depositary about its business with the fund.

The relationship between the AIF and the prime broker must also be disclosed to investors. Apart from the identity of the prime broker, investors must also receive a description of the business arrangements between the AIF and the prime broker, as well as any conflicts of interests that may arise in relation to those arrangements, and how the conflicts are mitigated. Investors must also be made aware of any provisions in the contract between the depositary and the prime broker which makes a transfer or reuse of AIF assets possible.

Collateral also plays a key role in the relationship between the hedge fund, the prime broker and the depository. AIFMD stipulates that the depository remains liable for restitution of in-custody assets, regardless of whether the assets are subject to repo, securities lending or collateral arrangements. The definition is that the asset remains with the depository, unless the title to the asset has been transferred. Different models might emerge to accommodate collateral arrangements in the most efficient manner.

Conclusion

- AIFMD will introduce quasi equivalent operating and reporting standards for managers of alternative investment funds and UCITS – UCITS V will rectify the “unintended anomaly” of higher interim AIFMD standards.
- Managers must be careful not to push authorisation out until mid 2014 – regulators and service providers might be limited in their ability to process all applicants and client changes in Q2 2014.
- The legislature and the industry have given considerable thought to how the overarching objectives of increased investor protection and transparency can be achieved. Compliance with AIFMD’s provisions should be considered with these objectives in mind.
- AIFMD impacts all actors in the fund value chain – also the current prime broker model has to be revisited as only one depository can safe-keep all fund assets.
- The administration service provider can support AIFMs in their compliance – an in depth dialogue about requirements and conditions will help define the optimal distribution of tasks.
- The depository’s role has changed fundamentally – the enhanced duties and liabilities require very close cooperation between the AIFM and the depository to minimise the potentially considerable cost impact on the investor.



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