Responding to the new reality
Alternative Investment Fund Managers Directive Survey

July 2012
Leading business advisers
## Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>3</td>
</tr>
<tr>
<td>Executive summary</td>
<td>4</td>
</tr>
<tr>
<td>Market perspectives</td>
<td>8</td>
</tr>
<tr>
<td>Product and distribution</td>
<td>14</td>
</tr>
<tr>
<td>Implementation</td>
<td>18</td>
</tr>
<tr>
<td>Conclusion</td>
<td>26</td>
</tr>
<tr>
<td>Respondent profile</td>
<td>28</td>
</tr>
<tr>
<td>How we can help</td>
<td>30</td>
</tr>
</tbody>
</table>
The Alternative Investment Fund Managers Directive (AIFMD) was born out of the financial crisis and drafted amid a storm of controversy that continues to rage.

For the first time managers of non-UCITS funds, both onshore and offshore, will be required to seek authorisation under a new and comprehensive EU regulatory framework. They will have to comply with a whole range of regulatory, organisational and operational requirements with far-reaching business consequences.

AIFMD has been officially published for over a year and combined with ESMA’s detailed technical advice, much of the new regime has been clarified. The European Commission’s delegated regulation will provide certainty with respect to a further number of contentious points. It is now not due to be published until September 2012, following a significant divergence of approach between the Commission draft and ESMA’s advice. Amid such controversy, it is easy to forget that AIFMD must be implemented nationally by July 2013 – a short 12 months away, given the scale of change required. As organisations move towards implementation, Deloitte conducted a survey of investment managers to determine how they plan to respond to the new regime.

This report highlights the key issues identified by managers, as well as some of the potential opportunities that AIFMD may bring. The survey results provide key insights into the industry approach to AIFMD, from implications for the market landscape, product development and distribution strategies to views on detailed implementation issues.

The results emphasise the need for managers to focus on the wider business impacts of AIFMD and their positioning in a changing and uncertain marketplace. We hope you find this paper a useful reference as you embark on your AIFMD implementation journey.

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Deloitte conducted a survey in May/June 2012 of UK based asset managers from across the hedge fund, private equity and real estate sectors. The respondents collectively manage over £175 billion and are evenly distributed across these three segments. The objective was to assess current industry sentiment and predict future trends that will arise as a direct consequence of the Alternative Investment Fund Managers Directive (AIFMD).

A less competitive “Fortress Europe”? Many commentators have suggested that AIFMD is a building block of “Fortress Europe” – a more protective European market sheltered from competition. The survey findings support this view, as 68% of respondents believe that AIFMD will lead to less non-EU managers operating in the EU. 68% also believe that AIFMD’s compliance burden will reduce the competitiveness of the EU’s alternative investment funds industry. In particular, larger managers are looking to take advantage of the reduced level of competition to grow their business.

Investor interests Enhancing transparency towards investors is among the principle aims of AIFMD and in this the Directive looks set to succeed, not just due to the investor disclosure provisions. Over half of respondents plan to provide investors with additional information as a result of AIFMD’s regulatory reporting requirements. This may, for example, include disclosure of all indirect transaction costs and further risk data.

However, the findings also suggest that increased transparency and investor protection may be counterbalanced by less choice and competition in the market, increased expense ratios, confusion over leverage figures and longer redemption terms in some cases. Nearly one quarter of managers expect redemption terms to be impacted by AIFMD and over half of respondents believe that leverage figures will “cause confusion among investors”. A key challenge here for managers will be communicating these changes effectively to their investors.

Managers believe that AIFMD will lead to a more protective and less competitive EU market.
Polarisation

The findings show that there is a polarisation of opinion among managers on AIFMD. Smaller fund managers and those focussing on private equity and real estate tend to take a more negative view of the Directive. This perhaps reflects the limited capacity of these managers to take advantage of the EU marketing and management passports while also having fewer internal resources to deal with the initial and ongoing compliance responsibilities.

Larger fund managers, particularly those with a focus on ‘regulated non-UCITS’, are more likely to see business opportunities in AIFMD.

These managers plan to use the EU passport to extend their fund distribution, enhance investor confidence through AIFMD-compliant funds and take advantage of any reduction in competition within the European market.
Betting on private placement and third country cooperation

61% of managers surveyed claimed that AIFMD will affect their choice of fund domicile, with the majority of these managers looking to continue establishing funds outside the EU or move funds offshore. It is therefore expected that managers will continue to set up both offshore and onshore regulated funds according to specific requirements and investor preferences. Importantly, managers are placing considerable faith in the unhindered continuation of private placement and the third country passport via the EU’s proposed cooperation arrangements.

AIFMD threats and opportunities

Threats
- Depository costs
- Delegation and substance
- Market routes/end of private placement
- Contractual changes
- Remuneration
- Non-EU provisions
- Operational change
- Authorisation

Opportunities
- Distribution/EU passport
- Investor confidence
- Reduced competition
- Level playing field
- Brand creation

Net business threat to the industry as whole

72% of respondents view AIFMD as a business threat. The foremost concern relates to depositary costs, with 84% of respondents viewing this as the most pressing issue. Other key concerns include delegation arrangements, market routes, changes in contractual arrangements and remuneration.

The extent to which these challenges are offset by advantages such as enhanced distribution or investor confidence varies, but for most, AIFMD’s costs outweigh any opportunities.
Individual managers are taking different approaches to AIFMD, which is perhaps to be expected across such a diverse sector.

Five key themes emerging from the survey

1. Smaller fund managers, private equity and real estate are more likely to see AIFMD as a business threat.
2. Larger fund managers with onshore funds are more likely to view AIFMD as a business opportunity and take advantage of the EU passport.
3. The number of non-EU managers operating in the EU is likely to fall.
4. The European alternative investment fund industry is likely to be less competitive.
5. EU managers will continue to use both offshore and onshore products depending on the scenario.

Positioning for the future

There is much uncertainty as to how the European market will look in six years’ time when the transitional provisions relating to private placement are due to come to an end. However, it is clear that individual managers are taking different approaches to AIFMD, which is perhaps to be expected across such a diverse sector that encompasses everything from retail non-UCITS to offshore hedge funds. Ultimately, there will be a trade-off for managers as to whether they want to remain in the EU or move offshore altogether, continue with private placement for as long as possible or operate fully under the EU passport to ensure unhindered access to EU investors. Each manager will have to make their own determination based on their business and distribution strategy and the nature of their investor base.
Overall, do you view AIFMD as a business opportunity or threat?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
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<tr>
<td>72%</td>
<td>28%</td>
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Many challenges but potential opportunities for some

Given the widespread concerns with the Directive and Level 2 measures, it comes as no surprise that a sizeable majority of respondents view AIFMD as a business threat. The depositary, marketing and remuneration provisions combined with the operational realignment required under AIFMD will have significant business impacts and these are reflected in the results. Some respondents commented that AIFMD will simply add extra costs for no benefit while others were supportive of the Directive’s original aims but felt the text took the wrong approach. There was widespread frustration with the rule-making process and the uncertainties that have prevailed since the first draft, which respondents considered contrary to the interests of investors.

Managers who saw AIFMD as an opportunity tended to be larger, managing at least £1 billion and several billion in most cases. These managers also tended to have an existing focus on ‘regulated non-UCITS’ in addition to other business areas. This group is presumably looking to extend the distribution of their existing range of EU-domiciled regulated funds under the new passport. Such funds might include retail non-UCITS funds or regulated funds for professional investors that permit greater investment flexibility, such as the Irish Qualifying Investor Fund (QIF). On the other hand, managers focused exclusively on private equity or real estate tended to take a more negative view of AIFMD.

Perhaps most interesting is that 28% of respondents saw AIFMD as a potential business opportunity.

While this group remain concerned about various aspects of AIFMD, most are seeking to utilise the new EU passport.

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What are the key concerns?

Depositary costs
Unsurprisingly, the depositary costs associated with AIFMD are the most pressing concern. Many managers will need to appoint a depositary for the first time and will face additional fees from depositaries for the safekeeping and oversight of assets falling under the strict and potentially expensive liability provisions. 84% of respondents are significantly concerned about the depositary costs that they will incur as a result of AIFMD. These costs could also rise further depending on the treatment of collateral under the depositary liability provisions in the Commission's final regulation.

Delegation and substance requirements
The delegation and substance requirements arising from the draft European Commission Level 2 measures are also of significant concern to 78% of managers. The Commission has added additional criteria that would set a quantitative limit on the tasks that the AIFM can individually delegate whereby these must not substantially exceed the tasks remaining within the AIFM. This is a significant change from current management company models based on the retention of control and oversight within the AIFM but the delegation of day-to-day activities to the portfolio manager and service providers. Under the Commission’s approach, the viability of internally managed funds may be called into question without significant in-sourcing. Managers may also be restricted in terms of the extent to which they can sub-delegate portfolio management.

Routes to market/private placement
Two thirds of respondents are concerned about routes to market post AIFMD and the phasing out of private placement. Once the transitional implementation period ends in July 2014, private placement will no longer be available to EU managers marketing EU funds in Europe, but the mandatory switch to an EU passport should enable continued distribution access within the EU. However, managers are still concerned about losing the private placement option and switching to a new and formal notification process.

Managers with non-EU funds face greater distribution uncertainty and it therefore comes as no surprise that two thirds of respondents are also concerned about the so-called third country provisions. Under these rules non-EU funds should be able to continue with private placement in the EU until 2018, with the option of availing of a ‘third country passport’ by 2015. However, continued access for non-EU funds is dependent on the signing of supervisory and exchange of information cooperation arrangements between all jurisdictions involved. Uncertainty over the signing and practical operation of these cooperation arrangements is a major concern for managers seeking to plan for AIFMD.

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Which aspects of AIFMD cause the greatest concern?

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Not concerned</th>
<th>Slightly concerned</th>
<th>Fairly concerned</th>
<th>Quite concerned</th>
<th>Very concerned</th>
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<tbody>
<tr>
<td>Depositary costs</td>
<td>5%</td>
<td>11%</td>
<td>37%</td>
<td>21%</td>
<td>26%</td>
</tr>
<tr>
<td>Delegation and substance requirements</td>
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<td>11%</td>
<td>28%</td>
<td>33%</td>
<td>17%</td>
</tr>
<tr>
<td>Market routes/end of private placement</td>
<td>11%</td>
<td>22%</td>
<td>11%</td>
<td>39%</td>
<td>17%</td>
</tr>
<tr>
<td>Changes in contractual arrangements/responsibilities</td>
<td>11%</td>
<td>22%</td>
<td>28%</td>
<td>28%</td>
<td>11%</td>
</tr>
<tr>
<td>Remuneration</td>
<td>11%</td>
<td>22%</td>
<td>34%</td>
<td>11%</td>
<td>22%</td>
</tr>
<tr>
<td>Non-EU implications (third country provisions)</td>
<td>17%</td>
<td>17%</td>
<td>17%</td>
<td>38%</td>
<td>11%</td>
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<tr>
<td>UCITS style risk management framework</td>
<td>24%</td>
<td>29%</td>
<td>29%</td>
<td>18%</td>
<td>0%</td>
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<tr>
<td>Leverage calculation methodology</td>
<td>22%</td>
<td>33.5%</td>
<td>33.5%</td>
<td>11%</td>
<td>0%</td>
</tr>
<tr>
<td>Reporting to regulators</td>
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<td>22%</td>
<td>22%</td>
<td>22%</td>
<td>0%</td>
</tr>
<tr>
<td>Initial authorisation process</td>
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<td>17%</td>
<td>28%</td>
<td>11%</td>
<td>5%</td>
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<tr>
<td>Professional indemnity insurance cover</td>
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<td>44%</td>
<td>22%</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>Disclosure to investors</td>
<td>39%</td>
<td>33%</td>
<td>11%</td>
<td>17%</td>
<td>0%</td>
</tr>
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</table>
Changes in contractual arrangements

Respondents are also concerned about possible changes in contractual arrangements and responsibilities arising out of AIFMD. While the board of a fund/management company currently assumes overall responsibility for the fund and delegates functions to various parties, these arrangements could change depending on the entity appointed as AIFM. That entity will assume responsibility for management of the fund with implications for how the delegation arrangements and responsibilities are allocated. Furthermore, portfolio managers authorised under the Markets in Financial Instruments Directive (MiFID) cannot simultaneously hold an AIFMD authorisation, and the interaction of MiFID and AIFMD was of concern to a number of respondents. For further details see the section on management company structuring and authorisation on page 18.

Remuneration

The provisions on remuneration are also of significant concern to over two thirds of respondents. The new remuneration principles form part of a wider EU initiative in the context of international commitments to address the perceived contribution of remuneration arrangements to excessive risk-taking in financial services and to harmonise remuneration provisions across financial sectors. As such, many of these rules were developed for banks and large financial institutions and present practical challenges in an alternative investment context. ESMA’s guidelines on remuneration are likely to present a marked change for many AIFMs, even once the principle of proportionality is applied. Accordingly, managers need to carefully consider the implications of these requirements.

Policies will need to be reviewed and changes made as appropriate to meet the general requirements. Significant changes may be required in the way AIFMs remunerate ‘Identified Staff’, with increasing emphasis on deferral into appropriate instruments and the introduction of retention periods. Consideration will need to be given both to meeting these requirements and managing the commercial impact for AIFs and individuals as well as the tax position.

Operational changes

Operational concerns include modifying a risk management framework to comply with new rules, calculating leverage according to ESMA’s methodologies and undertaking regulatory reporting. Implementing policies, processes and systems to fulfil these new requirements will require significant inputs in terms of resources, planning and technical expertise. Larger managers tended to view this operational change with less concern while some of the smaller firms were quite concerned about meeting these new regulatory requirements.

Where do the opportunities lie?

Which aspects of AIFMD will offer the greatest opportunities to your business?

The distribution possibilities afforded by the new EU passport were confirmed as the greatest opportunity for fund managers under AIFMD. However, attracting less than a third of respondents, the appeal of the EU passport is far from universal. ‘None of these’ was the next most popular answer, reflecting widespread concerns about the new regime and scepticism about any potential opportunities. Enhancing investor confidence, one of the principle aims of AIFMD, is viewed as an opportunity by just under a fifth of respondents. These respondents are most likely looking to appeal to certain types of investors that will value AIFMD compliance and a small minority of managers will seek to enhance their brand based on AIFMD credentials.

In terms of the implications of AIFMD for competition in the marketplace, 11% of respondents saw the creation of a level playing field through a common set of rules as an advantage. Interestingly, 15% of respondents believed that reduced competition in the EU marketplace will benefit their business. These managers take the view that AIFMD will create a barrier to entry for some managers, particularly non-EU firms, leaving greater market share for UK based and AIFMD compliant managers to exploit.
How do you think the market will respond to AIFMD?

- Create new product opportunities and target markets: 17% strongly agree, 44% agree, 28% neutral, 11% disagree, 0% strongly disagree.
- Create strong investor demand for AIFMD compliant funds: 21% strongly agree, 42% agree, 21% neutral, 11% disagree, 0% strongly disagree.
- Create a global standard for regulated hedge funds: 21% strongly agree, 21% agree, 47% neutral, 11% disagree, 0% strongly disagree.
- Lead to offshore funds re-domiciling to the EU: 39% strongly agree, 17% agree, 39% neutral, 5% disagree, 0% strongly disagree.
- Lead to less non-EU managers operating in the EU: 21% strongly agree, 47% agree, 16% neutral, 16% disagree, 0% strongly disagree.
- Reduce the competitiveness of the EU’s alternative investment funds industry: 37% strongly agree, 31% agree, 16% neutral, 16% disagree, 0% strongly disagree.
- Lead to EU funds re-domiciling offshore: 10% strongly agree, 32% agree, 26% neutral, 32% disagree, 0% strongly disagree.
- Drive EU managers offshore: 11% strongly agree, 26% agree, 37% neutral, 26% disagree, 0% strongly disagree.

How will AIFMD change the market landscape?

Comparisons with the success of the UCITS brand in the retail world have inevitably been drawn with AIFMD. However, a majority of 58% of managers surveyed do not believe that AIFMD will create a global standard for regulated hedge funds. Managers see continued use of well-established offshore routes and other domestic regimes for hedge funds, which will offer greater efficiency and flexibility with a lighter regulatory compliance burden. Most respondents were undecided or disagreed with the proposition that AIFMD could potentially create new product opportunities in the same way that UCITS has done. However, the findings point to a sizeable market for AIFMD compliant funds, even if these funds do not achieve the same dominance in the alternatives world as UCITS in the retail world, with over a quarter of respondents anticipating strong investor demand for AIFMD compliant funds.
Do you think that AIFMD will affect the choice of fund domicile you manage?

- Yes: 39%
- No: 61%

Offshore or onshore?
Respondents appear to have mixed views on whether AIFMD’s implementation will bring product onshore or drive managers offshore. When asked if AIFMD will affect their choice of fund domicile, 61% of respondents believed that it would. Of the group that think AIFMD will affect their choice of domicile, the majority plan to continue to set up funds offshore, followed by managers who intend to move funds outside of the EU in response to AIFMD. That the strict depositary liability regime does not apply to the private placement of non-EU funds is undoubtedly a foremost consideration for these managers.

The findings suggest a range of responses with some managers moving more funds onshore, others moving their funds or entire operations offshore and the majority seeking to maintain the status quo for as long as possible while complying with AIFMD. Each manager will have to determine their approach with regard to overall costs versus benefits, marketing strategy and investor requirements. The final outcome of the Commission’s regulation and the third country cooperation arrangements will be an important factor in that regard.

If you answered yes, do you plan to:

- Continue to set up funds in offshore (Non-EU) locations: 37%
- Move funds outside of the EU: 27%
- Re-domicile offshore funds to the EU: 18%
- Other: 18%

A smaller number of players in a less competitive market?
68% of respondents believe that AIFMD will lead to less non-EU managers operating in Europe. For some non-EU managers, Europe may only constitute a fraction of overall business while the cost of AIFMD compliance and therefore the barriers to entry may be too high. The exit of some non-EU managers combined with the moving offshore of some EU managers could mean that the range of market players in the EU may shrink significantly. At least 15% of respondents are looking to take advantage of this reduced level of competition. A majority of 68% also think that AIFMD’s compliance burden will reduce the competitiveness of the EU’s alternative investment funds industry. Are larger managers, that can more easily absorb the costs of compliance, set to dominate a more sheltered market with a smaller range of players? Could this lead to less choice, lower returns and higher costs for EU investors?

Are larger managers that can more easily absorb the costs of compliance set to dominate a more sheltered market with a smaller range of players? Could this lead to less choice, lower returns and higher costs EU investors?
58% of managers surveyed do not believe that AIFMD will create a global standard for regulated hedge funds.
Product and distribution

Do you think that AIFMD could impact on the investment strategy of your fund?

- Yes: 89%
- No: 11%

Will AIFMD impact product composition and selection?

AIFMD regulates the activities of the manager rather than the product itself and does not impose any investment restrictions or limits on leverage as such. Consequently, 89% of respondents considered that AIFMD should not impact on the investment strategy of their fund. However, some respondents pointed out that the new regime could more indirectly impact on product and investment choices. Some respondents were concerned about a potential reduction in available markets due to the new depositary liability rules. Depositaries may withdraw the provision of custody services in high risk markets or revise fees upwards. Consequently, investing in emerging and frontier markets could become considerably more expensive at a time when appetite for such markets is increasing rapidly.

Over a quarter of respondents believe that there will be strong investor demand for AIFMD compliant funds. Demand for regulated products has increased in recent years. Some investors will value the risk and liquidity management framework, independent oversight, strict liability and increased transparency that AIFMD will bring. Regulated alternative investment funds already have a sizeable market and continue to grow in popularity in the lead up to AIFMD. In the same way that sophisticated UCITS have carved out a niche, there is an existing market for regulated alternative investment fund products.

Pension funds, insurance companies and sovereign wealth funds are among the industry’s largest clients. Many of these entities will be subject to investment rules which favour AIFMD compliant funds (AIFs). Under Solvency II, investment in AIFs may carry a lower risk rating and consequently provide a more cost-effective investment. Large governmental bodies may also be required to or prefer to invest in AIFs. Respondents managing regulated non-UCITS were more inclined to view AIFMD as an opportunity, as they are already active in the onshore, regulated funds space. At the other end of the spectrum, some professional investors may be discouraged from investing if the costs of investing in an AIF are much higher than investing in other similar products.

Some investors will value the risk and liquidity management framework, independent oversight, strict liability and increased transparency that AIFMD will bring.

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1. However, AIFMs must set a maximum level of leverage for each fund taking into account various factors, such as the type of fund and the investment strategy. Also under the new reporting mechanisms, authorities may impose leverage limits on AIFMs if they believe their activity poses a systemic risk.
Over a quarter of respondents believe that there will be strong investor demand for AIFMD compliant funds.
The EU passport – the new UCITS?

The findings identified the new EU marketing passport as the single greatest opportunity under AIFMD, however, 59% of respondents do not intend to use it to extend distribution. This includes almost all of the respondents that saw AIFMD as a business opportunity plus a number of fund managers who saw AIFMD as a business threat. Some managers therefore see the distribution benefits of an EU passport but do not consider that it will be sufficient to compensate for all of the other costs associated with compliance. Can the EU passport mirror the success of UCITS? Most respondents do not appear to think so and there are some key differences between UCITS and AIFs.

Do you intend to take advantage of the new EU passport to extend the distribution of your non-UCITS funds?

Firstly, the EU passport is intended for professional investors only. By definition, there is not the same mass market that UCITS have in the retail space. Many managers doubt the existence of an ‘untapped’ market for such a passport and would rather continue to target a select number of investors through private placement. Secondly, UCITS filled an obvious gap in the international market. The current offshore structure is considered efficient and much of the target investor base is comfortable with this route combined with their own due diligence. This lessens the likelihood that AIFMD will become a universal standard in the same way that UCITS has dominated the retail world.

On the other hand, AIFMD will enable a whole range of non-UCITS funds across Europe to be more freely marketed to professional investors and therefore potentially provide a distribution advantage. With assets of €2.4 trillion and accounting for 29% of total European fund assets, the EU’s non-UCITS sector is significant in scale. While the AIF passport is foreseen for professional investors only, individual EU Member States will have discretion to permit access to retail investors, subject to additional requirements. AIFMD therefore presents the opportunity to more freely market these funds and to potentially develop a standardised non-UCITS retail product.

Would you consider reducing the number of management companies to take advantage of the AIFMD management passport?

Management company consolidation

Similar to UCITS IV, AIFMD provides a framework for managers to use a single management company passport to centralise operations throughout the EU. AIFMD will also enable a UCITS management company to manage AIFs by permitting a dual authorisation of a management company under both frameworks. However, 69% of respondents do not intend to take advantage of management company consolidation under AIFMD. One reason for this may be that alternative fund managers typically have a smaller and simpler organisational structure than traditional retail fund managers. Therefore, some alternative managers may not need to rationalise operations across jurisdictions. Depending on the nature of activities undertaken, organisational structure and the existence of cross-jurisdictional operations, management company consolidation may be appropriate. Managers that would like to rationalise but do not plan to may be mindful of the tax barriers that have arisen with respect to management company consolidation under UCITS IV.

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2 Source: European Fund and Asset Management Association (EFAMA) Quarterly Statistical Release (Q1 2012), May 2012.
Do you currently manage sophisticated UCITS?

Sophisticated UCITS – here to stay

At 28%, a significant proportion of respondents manage sophisticated UCITS. A number of factors might be expected to prompt managers to switch from sophisticated UCITS to AIFs. Firstly, the recent regulatory reaction to the use of complex UCITS has created speculation about the development of a two-speed UCITS framework while regulators seek to tighten controls. Secondly, the replication of some sophisticated strategies within UCITS can prove challenging and more costly with lower returns. Thirdly, AIFMD will provide a new regulated framework for alternative managers with greater flexibility than UCITS plus the advantage of an EU passport.

However, alternative investment managers will not be deserting sophisticated UCITS under AIFMD. According to the survey findings, all plan to maintain their existing UCITS ranges and some will manage and set up UCITS and AIFs going forward. No respondents plan on setting up only AIFs in future or switching their existing UCITS ranges to AIFs. Even though these managers have institutional client bases, UCITS and AIFs are perceived as different product segments. Managers value the distribution possibilities provided by the UCITS brand and would not want to incur the administrative and operational costs of switching authorisation. While some new funds may be set up as AIFs rather than UCITS, these are generally viewed as two different segments.

AIFMD will enable a whole range of non-UCITS funds across Europe to be more freely marketed to professional investors and therefore potentially provide a distribution advantage.
Well informed
The overwhelming majority of respondents consider themselves to have a good or detailed knowledge of AIFMD. Only 5% claimed to have a limited understanding of the requirements and implications of AIFMD. Yet this reported figure is likely to be higher in the wider industry, as those who responded to the survey are likely to be more knowledgeable on AIFMD than those who did not. Keeping up to speed on the latest developments can be challenging, particularly as the detail of the technical implementing measures is worked out. Firms will need to appoint an AIFMD project lead and allocate the necessary time and resources to a project team, if they have not already done so.

Knowledge of the requirements and implications of AIFMD

Authorisation and management company structuring
While the initial authorisation process did not rank as a major concern for most respondents, over two thirds of respondents are concerned about changes in contractual arrangements and responsibilities post AIFM. The whole issue turns on the question of who will be appointed AIFM. While the Directive left open the possibility of appointing the Board of a fund as the AIFM, the Commission’s draft regulation points towards a more centralised model of insourcing.

An entity cannot simultaneously hold a MiFID and an AIFM license, which means that portfolio managers seeking authorisation as AIFM will need to consider structuring arrangements. Furthermore, taking on the role of AIFM points to potential changes in contractual responsibilities currently with the Board, such as responsibility for valuations. Tax residency could also be called into question if the management of a fund shifts from one jurisdiction to another.

At the time of issuing this survey, the picture with regard to management company structuring and delegation was too unclear for managers to judge which types of entities they might establish as AIFMs. Managers will need to carefully weigh up their options against the final implementing provisions to determine whether it will be in their best interests to become the AIFM, maintain a self-managed fund or engage an external service provider to become the AIFM.

The overwhelming majority of respondents consider themselves to have a good or detailed knowledge of AIFMD.
Over two thirds of respondents are concerned about changes in contractual arrangements and responsibilities post AIFM. The whole issue turns on the question of who will be appointed AIFM.

**Who is the AIFM?**

- Portfolio/Risk Manager
- AIFMD authorised ManCo
- Self managed fund

**Implications**

- Responsibility for valuations
- Contractual arrangements
- Conflicts of interest
- Delegation
- Remuneration disclosure
- Tax residency
Which aspects of AIFMD do you believe will create an additional cost burden?

While not a top tier business concern, many firms anticipate that authorisation will be expensive, particularly the legal fees required to navigate the new rules.

**AIFMD and costs**

The greatest costs will relate to the depositary, with 78% of respondents considering these costs to be significant. 45% of respondents anticipate these costs to be considerable while over one third expect depositary fees to be high or major. The actual cost of depositary fees post AIFMD is likely to vary considerably for managers depending on the nature of the investments and their risk profile. Consequently some managers may anticipate major costs due to the operational risk involved in the custody of their fund assets while a substantial group of managers expect relatively modest depositary fee increases. This may be due to the perceived security of their fund assets or because certain assets, such as OTC derivatives, private equity shares and real estate will not fall under strict liability. Additionally, offshore funds will not have to comply with the strict depositary liability regime until private placement is terminated in 2018.

Further costs will be incurred which, taken individually, the majority of respondents rate as relatively minor. However, the key point is perhaps that all of these minor costs will add up to considerable expense in terms of operational and organisational change and ongoing compliance. Of these costs, authorisation ranks the highest. While not a top tier business concern, many firms anticipate that authorisation will be expensive, particularly the legal fees required to navigate the new rules, which were included in the comments under ‘other’ costs.
Do you currently use a single, independent depositary for each fund you manage?

- Yes: 44%
- No: 56%

Depository changes
The majority of managers surveyed do not currently appoint a depositary for each fund managed. A whole range of entities will, under AIFMD, be required to appoint a single, independent depositary for the first time. Private equity, real estate and offshore funds will have to become accustomed to the new depositary oversight arrangements, representing significant operational change and a new level of due diligence.

The full depositary regime will not apply to non-EU funds during the transitional period, but an EU AIFM marketing a non-EU fund into the EU under private placement must appoint one or more entities to carry out the duties of a depositary under AIFMD. Managers may require additional support from service providers to carry out these functions, which cannot be performed internally. The third country passport, due to come into effect from 2015, will require compliance with the full depositary regime. With the planned termination of private placement in 2018 every AIF will be required to appoint a depositary subject to rules with the ‘same effect’ as the EU depositary regime.

Does your prime broker currently provide depositary services to your funds?

- Yes: 24%
- No: 76%

Prime broker considerations
Almost one quarter of respondents currently use their prime broker for custody type services that AIFMD will require to be performed independently of the prime broker function. A prime broker cannot act as depositary unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker. Prime brokers will be required to facilitate the flow of information to the depositary requiring new models of interaction and system integration between prime brokers and depositaries. Depositaries will be strictly liable for assets held in sub custody and will therefore need to be comfortable with the prime broker arrangements, processes and systems. Managers will need to enquire with their prime broker whether it can appropriately separate its custody function, whether it is prepared for depositary oversight and whether it has a recommended depositary which is willing to work closely with it.
Almost one quarter of respondents currently use their prime broker for custody type services that AIFMD will require to be performed independently of the prime broker function.

Engaging service providers
Two thirds of respondents plan to fulfil AIFMD’s operational requirements through in-house resources with the remaining third seeking external support. Over 20% of respondents did not answer this question which indicates that a proportion of managers have yet to decide whether they will engage an external service provider.

If yes, which services will you require assistance with:

- Regulatory reporting: 45%
- Complex and illiquid asset valuation: 33%
- Liquidity profiling: 22%
Reporting will be required for each fund either on a quarterly, bi-annual or annual basis, depending on the level of assets managed by the AIFM. ESMA has prescribed a 16 page template requiring detailed reporting on investment profile, risk, liquidity and leverage. Some managers will seek to outsource this complex process to a specialist provider that can provide a more streamlined and cost effective solution.

The Directive includes additional controls around the valuation of complex or illiquid assets and has clarified that the AIFM is ultimately responsible for the valuation of the assets. ESMA’s Level 2 advice also clarified that a third party administrator incorporating values obtained from the AIFM or other sources is not the “external valuer” by virtue of this activity alone. Under these circumstances some AIFMs may seek to appoint their administrator as an external valuer. A third of respondents seeking external assistance will look to appoint their fund administrator to value complex or illiquid assets.

AIFMD will require managers to develop a liquidity monitoring system to ensure that the liquidity of the underlying assets is aligned with the redemption policy. Fund administrators are well positioned to perform this liquidity profiling and to provide data analysis for the required liquidity stress testing. The survey suggests that over a fifth of managers seeking external assistance will require liquidity profiling.

**Will the liability placed on the AIFM for valuation increase your oversight of the fund administrator?**

- Yes: 22%
- No: 78%

A minority of managers surveyed will seek to increase scrutiny of their fund administrator due to the liability that AIFMs will now hold for valuations. However, a large majority of managers are satisfied with current valuation arrangements. ESMA’s advice generally approaches valuations from a high level principles perspective, incorporating current best practice. Many firms may therefore view the current level of oversight as sufficient.
The majority of managers surveyed intend to provide investors with new information arising out of the regulatory reporting.

**Regulatory reporting and additional transparency**
Although reported only to competent authorities, the regulatory reporting required under AIFMD is likely to lead to greater transparency for investors more generally, according to the survey findings. Once implemented investors may place pressure on managers to reveal information from the regulatory report as part of their investment due diligence. The majority of managers surveyed intend to provide investors with new information arising out of the regulatory reporting. Considering the commercially sensitive nature of some of this reporting, it remains to be seen what information managers will be willing to disclose. This may, for example, include disclosure of all indirect transaction costs and further risk data.

**Liquidity management and redemption terms**
The key aim of AIFMD’s liquidity management framework is to ensure alignment of the investment strategy, liquidity profile and redemption policy so that investors will be able to redeem as per the redemption policy and also in a manner consistent with the fair treatment of all investors. AIFMs will need to disclose the use of any special arrangements (such as gates or side pockets) prior to investment and develop policies and procedures for the management of liquidity.
For a minority of managers, the liquidity provisions may result in modification of the redemption terms for investors. Some managers may lengthen the redemption terms in order to provide greater flexibility and ensure compliance under the new liquidity framework. Others may alter their policies with regard to special arrangements but most plan to leave the current redemption arrangements in place. In any event liquidity management policies and procedures will need to be reviewed and updated while new information on liquidity will need to be reported to regulators and investors.

**Do you think disclosure of leverage figures under the UCITS commitment approach will cause confusion among investors?**

- Yes: 56%
- No: 44%

**Disclosure of leverage**

The calculation and disclosure of leverage under AIFMD has been a contentious issue for managers during the drafting process. Managers must use both the gross and the commitment method to calculate and report leverage. The ‘gross’ method does not permit any netting and hedging arrangements while the ‘commitment’ method permits only some netting and hedging. ESMA’s advice also provided for an ‘advanced’ method, which the manager could additionally use when it considers that there is a more accurate measure of exposure, such as using a Value-at-Risk (VaR) methodology.

The Commission’s initial draft regulation provided only for the gross and commitment approaches, although this position may change in the final text. A key concern in relation to the commitment approach is that this methodology allows less flexibility to offset various exposures when using derivatives and could result in the disclosure of figures that may not represent the true level of leverage in the fund. As a result, the majority of respondents believe that the commitment approach will cause confusion to investors. Educating investors on the methodology surrounding the commitment approach will be critical in overcoming these concerns.

**Will you need to take out additional professional indemnity insurance cover?**

- Yes: 33%
- No: 67%

**Professional indemnity cover**

The AIFMD implementing measures specify a list of potential liability risks which must be covered by AIFMs either through additional own funds or professional indemnity insurance (PII). One third of respondents will need to increase their professional indemnity insurance cover as a result of these new requirements. Differences between the Commission’s draft regulation and ESMA’s approach to PII cover could potentially impact the way the managers structure their cover. Managers will not have complete certainty with regard to these arrangements until the final Commission regulation is released.
AIFMD will shape the investment management landscape in Europe and beyond for years to come. Its implications will go beyond regulatory compliance and operational change to affect distribution, business strategy and market composition.

It is impossible to predict how the market will look in 2018 when private placement is due to be switched off completely and full AIFMD compliance required in all scenarios. How UK managers respond to this challenge will define their market positioning in the new era.

The findings suggest that most UK managers with non-EU funds are likely to maintain private placement for as long as possible and will continue with the practice of setting up offshore and/or onshore funds, while ensuring AIFMD compliance. Some may consider moving funds or their entire operation outside of the EU. However, any move offshore may only prove a temporary reprieve from AIFMD for managers marketing to EU investors, as full AIFMD compliance will be required by 2018.

At the other end of the spectrum, some UK fund managers are embracing AIFMD as a business opportunity. This group tend to be larger managers who are already active in the regulated non-UCITS market. These managers are seeking to extend the distribution of their non-UCITS funds through the new EU passport and take advantage of a level playing field across the EU. They tend to view AIFMD compliance as a means to enhance investor confidence and are therefore more likely to re-domicile funds onshore.

AIFMD may prove too onerous a compliance burden for some non-EU managers relative to their interest in the EU market. This may result in less non-EU managers operating in Europe and, combined with the exit of some EU managers, could lead to a significantly smaller number of players in the European market. Opportunistic managers are seeking to take advantage of this anticipated reduction in competition.

The survey findings also suggest that the European alternative investment fund industry is likely to lose competitiveness owing to the compliance burden of AIFMD and particularly the cost of the depositary liability provisions. Larger managers will be better placed to absorb these costs and are more likely to view operational realignment as a less daunting challenge. Scale will be a clear advantage when it comes to addressing the challenges and exploiting the opportunities of AIFMD.

However, even larger fund managers are concerned about the prospect of new delegation and substance requirements under the Commission’s draft regulation, as these changes may have a profound impact on current management company and outsourcing models.

Can the EU passport compensate for the costs imposed by Directive and will AIFMD become the global standard for regulated alternatives? The majority of respondents do not agree. After a brief period of decline, offshore centres are thriving again. The US has not gone as far as Europe in its drive to regulate alternative investment funds and managers there, and in other large and growth markets, will not be subject to the same requirements.

However, the survey findings indicate that there will be significant, albeit not universal, demand for AIFMD compliant funds. With thousands of non-UCITS funds falling within scope, AIFMD is a force to be reckoned with. Ultimately, it is the investors who will decide AIFMD’s success as a global brand. Much will also hinge on the final outcome of the detailed implementing measures and the third country cooperation arrangements.

Conclusion

AIFMD will shape the investment management landscape in Europe and beyond for years to come. Its implications will go beyond regulatory compliance and operational change to affect distribution, business strategy and market composition.
Respondent profile

Deloitte conducted the survey of UK based asset managers in May/June 2012.

The respondents collectively manage over £175 billion in alternative investment strategies. The business area and most important investor groups are broken down as follows.

### Business area

- **Private equity funds**: 26%
- **Regulated non-UCITS funds**: 23%
- **Hedge funds**: 20%
- **Real estate funds**: 18%
- **Fund of hedge funds**: 13%

### Most important investor groups

- **Pension funds**: 32%
- **Fund of funds**: 21%
- **Insurance companies**: 17%
- **Sovereign wealth funds**: 15%
- **HNWs**: 9%
- **Retail investors**: 3%
- **Banks**: 3%

### Primary fund domicile

- **UK**: 28%
- **Ireland**: 17%
- **Cayman Islands**: 17%
- **Luxembourg**: 17%
- **Guernsey**: 9%
- **Jersey**: 9%
- **Other European domicile**: 9%
- **Other offshore domicile**: 9%
- **4%**: UK
- **7%**: Ireland
- **9%**: Cayman Islands
- **9%**: Luxembourg
- **9%**: Guernsey
- **9%**: Jersey
- **9%**: Other European domicile
- **4%**: Other offshore domicile
AIFMD poses a major business, operational and compliance challenge for organisations. Deloitte has the resources and expertise to help you meet this challenge, identify the correct business strategy and prepare and implement a compliance plan.

How we can help

AIFMD compliance plan

1. Regulatory analysis
2. Function analysis
3. Re-align organisation and functions
4. Create new functions
5. Develop policies and processes
6. Outsourcing

Leverage existing UCITS and MiFID systems

AIFMD Compliance

- Governance/organisational
- Authorisation/capital/PII
- Remuneration framework
- Marketing documentation
- Appoint depositary/address counterparty relationships
- Risk management/liquidity framework
- Valuation arrangements
- Reporting/disclosure

Our Investment Management Advisory Group can assist you with:

- AIFMD strategic analysis and business planning
- Regulatory gap analysis, impact assessment and compliance plan
- Change implementation
- Risk management and valuations governance
- Fund distribution services
- Service provider assessments
We are the world’s only full-service professional advisory firm combining expertise in assurance/risk, regulatory, taxation, operational and strategic consulting to deliver an integrated solution for your business through our Investment Management Advisory practice.
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