Deutsche Bank
Global Transaction Banking

White Paper

Charting a smooth course through AIFMD implementation

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The route ahead

Designed to establish a harmonised regime across the EU for various forms of alternative investment fund (AIF) management, including hedge funds, fund of funds and private equity, the Alternative Investment Fund Managers Directive (AIFMD) is scheduled to come into effect on 22 July 2013. AIFMD will certainly impact responsibilities, liabilities and risk for EU AIF managers and their prime brokers, depositaries, administrators, and custodians, but with the right approach, implementing its provisions need not be as disruptive as some fear.

Since 2008, the entire financial services industry has been contending with wave upon wave of new regulation. For the EU's alternative fund management sector, however, 2013 will be all about the Alternative Investment Fund Managers Directive (AIFMD).

Any measure that seeks to increases investor confidence – in the case of AIFMD, through the reduction of systemic risk and the enhancement of investor protection – is to be welcomed. That said, AIFMD has been greeted with some degree of scepticism since it was first mooted back in 2009. Its detractors – including industry bodies like the European Fund and Asset Management Association and the Association of Global Custodians – contend that complying with AIFMD adds cost and complexity to a system that did not need fixing in the first place. Institutional investors – particularly alternative investment fund (AIF) managers – are well aware of the risks involved, say the detractors, and there are effective measures already in place at both individual investor and market-level to mitigate them. There have also been concerns expressed about the impact AIFMD will have on the competitiveness of the EU's AIF industry.

Perhaps as a result of this criticism, many of the practicalities of AIFMD implementation are still in flux and we are likely to see the minutiae change in the run-up to 22 July – and perhaps beyond – as the industry adapts to the new Directive in the most pragmatic way possible.

What will not change however, are the fundamentals of AIFMD and their impact on every player in the EU AIF sector.

AIF managers in the EU must therefore ensure they have a good understanding of the short and long-term effects of the Directive on their business and plan accordingly. They will need to appoint a depositary and make the changes needed to their systems to meet the reporting requirements of the Directive. It's with these AIF managers' needs in mind that we offer this paper – to outline the changes and challenges that AIFMD presents and to offer a view of how best to navigate the new landscape.

A subtle shift of power

AIFMD brings AIFs under an unprecedented degree of regulatory scrutiny. One of the key requirements is that all AIF managers must appoint a depositary to be responsible for three things:

– safe keeping of assets (or, in the case of non-clearing assets, asset verification);
– monitoring the cash movements between the AIF manager, its underlying funds and all of its counterparties; and
– providing general oversight of the fund's investment activities to ensure they adhere to its governing documents.

These provisions significantly increase the breadth and importance of the depositary's role – a higher profile role that comes at a cost for depositaries since their work load, tracking, monitoring and risk increases accordingly. Indeed, a key point of AIFMD is the strict liability provisions that apply to the depositary. The depositary for an AIF will be held liable for the loss of any financial instruments that they directly hold in custody on behalf of the AIF. It will also be held liable for the loss of financial instruments that are held in sub custody accounts with a third party. Typically, the depositary will treat the AIF's prime broker as a sub custodian but the depositary retains the liability.

Although the fund manager continues to be responsible for appointing its own prime broker and fund administrator, the depositary's oversight role – and the liability it assumes as a result – means that it is likely to want to exercise influence over those decisions. Certainly, the depositary will want to carefully consider operating models to ensure it has the control it needs and reassurance that the assets are properly segregated from non AIF assets. In simple terms, depositaries are going to want to work with prime brokers, fund administrators and custodians that they know, trust and have a solid financial backing.

In practice, this may translate into only offering services on the condition that they also act as the fund administrator as their cash monitoring function will require them to validate the cash flows of the funds, traditionally a fund administrator's role. Depositaries may also want a say in the relationship that AIF managers have with their chosen prime brokers. Indeed, there have been a number of industry-wide committees formed to reach consensus on how depositaries and prime brokers will interact.

These new dynamics are making some fund managers understandably uneasy. The relationship between a manager and its prime broker remains the most valued in the chain. It is the prime broker, after all, that supports the manager in executing its investment and trading strategy. Allowing the prime broker to do so while keeping costs low (for example by enabling it to hold the assets and borrow against them) is in everyone's interests.

The key will be in adopting an operating model that fully complies with the directive while minimising disruption to the existing roles and relationships.

One way of achieving this, in our view, is an integrated model. We believe that AIF managers would be best served by consolidating their business with depositaries equipped to work with their existing prime brokers and that can also act as fund administrators, cash managers, transfer agents, and sub-custodians within a framework of appropriate "Chinese walls" and segregation of duties.

Regardless of the model they choose to adopt, one thing is certain, with the implementation of AIFMD imminent, fund managers should be engaging with depositaries now. While there are about 10,000 alternative funds being managed in the EU today, there are only 28 depositaries. Since there is a practical limit to the number of funds that can be taken on in a relatively short period of time, managers should address their depositary needs with a real sense of urgency.

The true impact of the depositary's expanded role

Before elaborating on why we favour an integrated model, it is useful to have a closer look at what the depositary's expanded role means in practice.

The obvious impact is that depositaries, for the first time, will be underwriting potentially huge levels of risk – substantially more than under the current regulatory regime. As they will be required to delegate sub custody to prime brokers (for which they still retain liability), there will be increased scrutiny on the operational effectiveness of both the prime broker and the prime broker's sub custodian network. As a result, it's feasible that liability concerns may lead some to withdraw from certain geographical markets and/or asset classes. Only depositaries with sufficient size, geographic reach and capital will be able to make the necessary provision for their potential liabilities. Together, these factors are expected to fuel significant industry consolidation – an unintended, and perhaps undesirable, consequence of the Directive.

Those that remain will have to adapt to the operational demands integral to this more central role in the value chain. Almost all depositaries will need to upgrade – to varying degrees – their existing capabilities. As depositaries prepare to become responsible for the restitution of financial instruments in the event of a loss, such enhancements will need to focus on three key areas.

Due diligence

Since depositaries must ensure that sub custodians (which, because of the existing model in which prime brokers hold the fund's assets and use them for rehypothecation, might well be prime brokers and their sub custodians) are "fit for purpose", regular market level due diligence will be required with the depositary reserving the right to demand a change if the custody risk is deemed too high with a market or a sub agent.

Cash monitoring

The ability to monitor all cash movements of AIF assets will be essential. Being able to accurately track and break down the movement of trillions of dollars of client monies potentially across thousands of bank accounts globally and pinpoint their precise position at any given time – will require superior overview positions powered by heavyweight technological capabilities.

Liability

Finally, depositaries may also want to offset liability – for example, by acquiring indemnifications from delegated parties (i.e. sub custodians or prime brokers). The industry's model for doing this has yet to be decided – and once again, active and ongoing market dialogue is vital.

An integrated model

So, hand in hand with a broader remit, AIFMD shifts liability – and therefore risk – on to the depositaries. This is likely to lead to consolidation and, for many of those depositaries that remain, the need to improve their systems and processes to meet the requirements of the Directive and deliver the service-levels expected by fund managers.

Of course, this poses the question: what model will work best to minimise disruption and expense to the industry?

While the ideal model for AIFs might have to be developed individually with all parts of the chain, an integrated model – in which, depositary services, administration, cash management, corporate administration, sub custody and potentially one of the prime brokers (in a multi prime broker model) is provided by the same organisation – has several important advantages, not least that it leverages the efficiencies and cost-savings inherent in a larger, global providers' domestic network and capabilities.

Models that split depositary and administration services will most likely result in higher costs. This is due to the replication of the processes, procedures and systems infrastructure required to ensure that AIFMD rules around cash management and asset safekeeping are met. Since this extra layer will no doubt be priced into the cost of services rendered, the AIF manager could effectively pay twice to have similar processes performed. The depositary has to have its own complete records therefore has an obligation to build the records based on its own policies and procedures. There is inherent inefficiency in splitting the roles.

An integrated model, meanwhile, can avoid such duplication and offer cost benefits while more effectively mitigating risks (by allowing the provider to retain tight control of the assets). This increases visibility – keeping everything in line-of-sight through internal systems and controls. In addition to being more secure, this reduces the administrative burden, and – through greater transparency – aids compliance.

Time for action

As AIFMD's July implementation date nears, one thing is clear: AIF managers must be aware of the urgency of preparing for the Directive's implementation and discuss their individual needs with their depositaries immediately. It is only by understanding the full impact of the upcoming changes that fund managers will be able to adapt accordingly.

While AIFMD will certainly change roles and responsibilities for those involved – and perhaps unwittingly have some undesirable consequences – the Directive should ultimately increase investor confidence. That is to be welcomed. Our aim should be to achieve those goals while minimising the cost and disruption to the industry. An integrated model – one that mitigates risk, reduces costs, and maximises the advantages of these changes – will often be the best way of doing so.

Deutsche Bank and AIFMD

The Deutsche Bank Group provides depositary services, award-winning fund administration, globally aligned investor services, multi-currency cash management and a highly regarded sub custody network in over 30 markets around the world. It also has a prime brokerage business.

As a truly universal bank, renowned for innovation, we can offer fund managers all the core components and capabilities they might need.

To those for whom we already act as prime broker, we can also offer depositary services with fully integrated administration and custody capabilities.

For clients electing to use a third party prime broker, our open architecture, flexible technology and deep expertise make working seamlessly together as straightforward as possible.

Our commitment to AIF clients is simple: to minimise disruption while offering the most cost-effective way to comply fully with AIFMD.

For more information, please visit www.db.com/gtb

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