IFI Global

The impact of AIFMD on the European & US alternative fund industries

Results of research with European and US managers 2015

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Introduction

The introduction of the AIFM Directive is a moment of great significance for the development of the European alternative asset management industry. It is also of much importance for some alternative asset managers in other parts of the world.

Over the last 18 months IFI Global has conducted two research studies on the impact of AIFMD on the alternative fund industry. The first of these was done during the Directive's transitionary period, early in 2014. By contrast the fieldwork for this year's study was done well after the Directive had come into full effect, over the summer and autumn of 2015. IFI Global wanted to find out if forecasts managers made early in 2014 in our previous survey, on the eve of its introduction, turned out to be accurate a year or more later, after they had had a chance to get used to life under the Directive.

This year IFI Global decided to also find out how US alternative fund groups view the Directive. There has been much comment on what Americans think about AIFMD but, until now, no research has been done on this topic.

The main areas of focus in this year's survey are those identified by managers in the one 18 months ago as being the most challenging to implement. The 2015 study has focussed on the areas that appeared most likely to bring structural change to the alternative fund industry back in early 2014. Consequently this year's European survey focuses on risk management issues and AIFMD ManCo platform

development. The US side of this research also covers ManCo platforms and addresses the question of how American managers' attitudes to the European alternative fund market might have been changed by AIFMD.

IFI Global would like to thank the very many people who helped us put this survey together, especially those that put our researchers in touch with alternative managers in the US. Equally we would like to thank the managers and their advisors who participated in this research study. And we would also like to thank Crestbridge and StatPro, the two sponsors of this project.

Overall summary and conclusions

- AIFMD has not had the critical impact on the industry that some of those interviewed 18 months ago feared it could well have. Survey responses in 2015 suggest that the industry has come to terms with the Directive with less difficulty than many expected. Managers surveyed have largely succeeded in incorporating specific AIFMD requirements in to their established and existing ways of running their businesses. AIFMD is therefore being adapted to existing industry templates – rather than the other way around.
- The same point largely applies to the US. US managers still take an opportunistic, investor-led approach to Europe. AIFMD has not caused them to take a strategic decision either to expand into Europe or to stay out of it. (Some US managers surveyed 18 months ago said that they would withdraw from Europe as a result of AIFMD.) US managers surveyed in 2015 said they will become AIFMD compliant if they believe there are sufficient investors for their funds to make this worthwhile.
- Survey responses suggest that alterations to practices in the industry wrought by AIFMD will in effect be part of a long term process of change rather than a one-off revolution. This applies in particular to the outsourcing of certain activities such as risk reporting to third party providers. In this area of the business, as in others, AIFMD has led to an increase in demand for specialist providers of services like Annex IV reporting, for example, but it has so far not been on the scale of what was envisaged 18 months ago. Equally the vast majority of managers, without appearing to give the matter much thought, have picked the depositary service provided by their fund administrator rather than turning to an independent third party provider. Over the coming years there will likely be further growth in specialist services in risk, depositaries and other areas. But, based upon the views expressed by many survey respondents, this will be steady long term growth rather

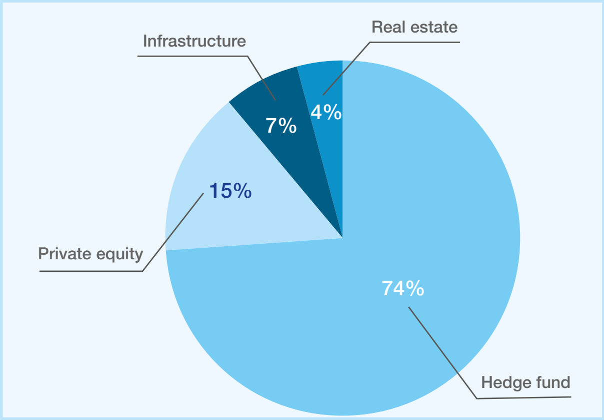
Overall summary and conclusions

survey respondents, this will be steady long term growth rather than anything more akin to a sudden surge envisaged 18 months ago.

- This point particularly applies to fund domiciliation patterns. AIFMD has not affected fund domiciliation – at least yet. But the end of private placement, should that occur, could well change that. No one surveyed is yet looking to access AIFMD parallel regimes that have been established in offshore centres.
- Based upon these survey results there should be further significant growth in third party AIFM ManCo platforms. These entities are popular with managers on both sides of the Atlantic. ManCo platform development, something first introduced to the fund industry in the wake of UCITS III, will almost certainly be the greatest structural change to Europe's alternative business triggered by AIFMD. It is possible ManCo platforms will become more popular on the AIFMD side of the industry than on the UCITS one in the future.
- One of the main reasons for AIFMD was to develop strong and professional standards of risk management on the alternative side of the investment industry. Many smaller managers surveyed 18 months ago were concerned about the breadth and the quantity of risk reporting demanded by the Directive. Overall, 78% of European survey respondents said that AIFMD has had an impact on the industry's approach to risk management. The survey results suggest the smaller the manager the more likely its risk management processes have been impacted by AIFMD. But only 12% have outsourced risk management functions to a third party provider.
- Risk reporting is an issue. 26% have employed new systems to cope with the substantial quantity of additional reporting required under the Directive, or are looking to do so.

Europe

IFI Global interviewed European based managers with a combined AUM of $214.6 bn of alternative fund assets.



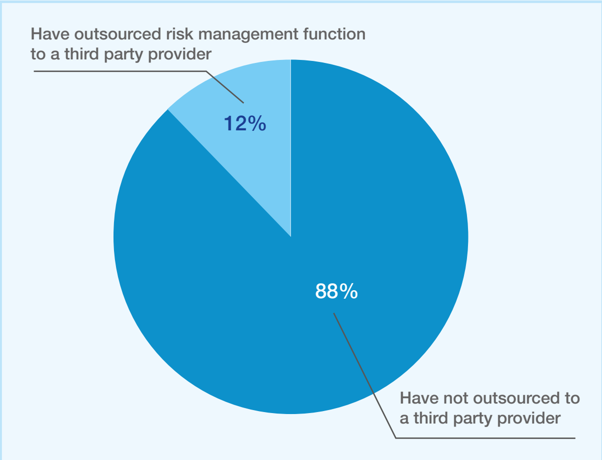
Summary

- The European alternative fund industry is learning to live with AIFMD. It has not been catastrophic event that was forecast by some in previous surveys conducted by IFI Global. Many managers surveyed said that, overall, they have found adapting to the Directive to be less onerous than they feared.
- The biggest impact of the Directive is on risk, particularly on risk reporting. And many managers surveyed are aware that risk oversight at board level is an issue that will need to be improved.
- Whilst there has been some growth in outsourcing to specialist providers of services needed to meet AIFMD regulatory requirements it has not has been nearly as great as forecast by many 18 months ago. Larger managers surveyed say they have the functionality needed for AIFMD in-house, especially if they are part of larger organisations with established UCITS fund ranges. And several smaller managers surveyed said that the merits of outsourcing did not pass their own cost-benefit analysis. As a result many of the smaller managers have taken on AIFMD tasks, such as risk reporting, themselves.
- AIFMD is therefore responsible for a big increase in multi-tasking by senior management at smaller European alternative fund houses - especially by CEOs, Finance Directors and COOs. In a very competitive environment, with relatively thin margins (compared to the pre-crash era) many small managers might well be struggling. But AIFMD is just one of a number of reasons for this.
- AIFMD ManCo platforms are likely to be used by significant numbers of the sub $1 billion managers interviewed in the coming years. They are also of interest to a number of larger independent European managers interviewed (but not those that are part of larger organisations with established UCITS fund ranges).

Risk management

One of the principal reasons for the AIFM Directive's introduction is to develop strong and professional standards of risk management in the alternative investment industry. This study has sought to find out how the industry has developed its risk management capabilities as a result of the Directive. The survey results show that AIFMD has had the biggest impact on smaller managers.

78% of respondents said that AIFMD has had an impact on the industry's approach to risk management. But many of the largest managers that were surveyed reported it has not had any significant effect on them.



The 22% that stated that AIFMD hadn't impacted them are larger managers that had revamped that their risk management in the wake of the market crisis. One of the common themes to emerge from this study is that many managers with AUMs of over $1 bn had decided to invest in improving their risk management well before AIFMD came along. A number of survey respondents in this category said that there is now more concentration on enterprise risk issues and a more forward looking approach. Also, investors have more interested in managers' risk management processes since 2008. This was a major incentive for managers to make improvements. AIFMD has therefore had relatively little impact on larger managers risk processes because of the changes that they had already made prior to its introduction.

Managers with AUMs below $1 bn are much more likely to have had their risk management processes affected by AIFMD. But less than one quarter of survey respondents in this category have allocated extra resources to this effort – either in hiring extra staff or outsourcing risk functions to a third party provider of these services. A number of these are however looking at third party outsourced options at present.

Risk management

Selected comments:

“There is additional focus on enhancing and formalising certain policies to ensure they are robust and fully documented”

“AIFMD’s requirement necessitates a focus on developing risk management as well as adapting or updating current systems/ processes for an evolving business”

“We are formalising our processes to create an audit trail of our risk management activities because of AIFMD but it will be no real benefit to our investors”

“Measurement means historical numbers; it is another part of performance disclosure whilst risk management is forward looking – in other words anticipating what might happen and what to do about it”

”Risk management used to mean market risk. Now people are much more aware that they need to have a risk management service that is more driven by strategic requirements, strategy and risk positioning”

“AIFMD has had nothing to do with any of the positive developments in risk management; it is just a reporting requirement”

“AIFMD focuses on market risk not the whole spectrum of risk”

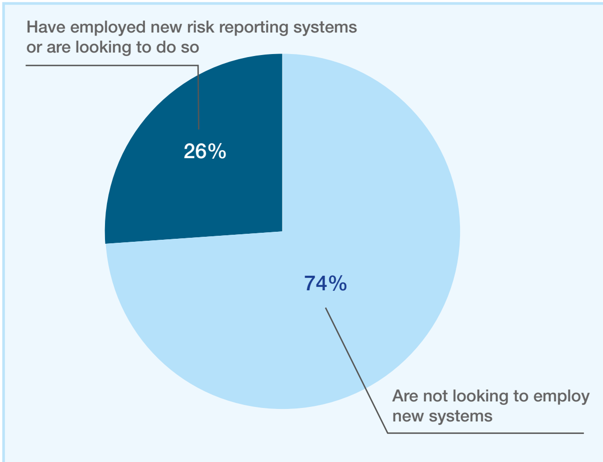
Risk reporting

Managers say that AIFMD has required them to include extra items in their risk reporting. Several survey respondents also made the point that these were not standard measures in the industry prior to AIFMD - and a number of these suggested much of what they are doing in this regard is of no benefit to their investors.

But the majority of respondents said wholesale changes to their systems have not been required, despite the extra reporting functionality that they have to undertake as a result of the Directive.

26% have employed new systems to cope with the substantial quantity of additional reporting required under the Directive (to the board, regulators etc) or are looking to do so.

The main impact of AIFMD has been on the quantity of reporting and breadth of what managers are required to report. The majority of smaller managers surveyed are reluctant to call in outside help for these functions.



Risk reporting

Selected comments:

"We met with and considered using outside firms to assist, but decided that currently it was best to utilise our internal systems to produce these reports"

"Reporting is very granular and places additional demands on the business to prepare and review but it is best done by us"

"Horrific. Extremely complicated and almost designed to encourage people to use an outside firm"

"We have experienced many frustrations trying to complete the process through Gabriel"

"Our administrator has helped us, and they have partnered with a specialist technology reporting firm"

"Incredibly laborious but gets easier as you get into it"

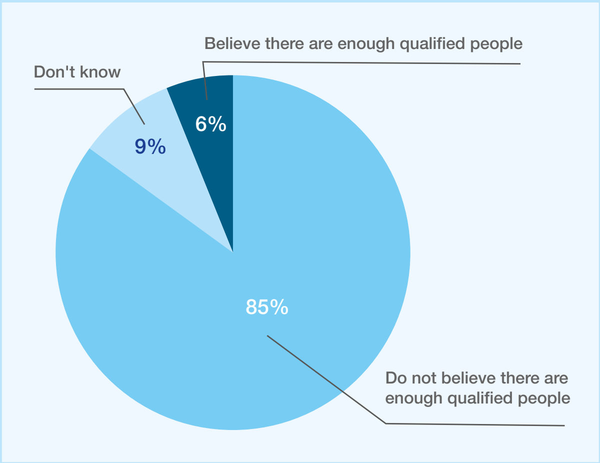
"We are considering using an outside firm but are questioning the value-add as the firms we have spoken to so far are expensive and require us to do more of the work than them"

Board risk

A key requirement of AIFMD is to make sure that risk management is properly supervised at board level - in the jurisdiction where the fund is domiciled. If portfolio management activity is not done where the fund is domiciled then the supervision of risk management has to be carried out in the fund's home jurisdiction. Fund boards that fall under the AIFMD now bear substantial responsibilities that are codified by the Directive.

As the AIFMD era unfolds there could well be lawsuits against the directors of regulated AIFs if the fund collapses and the directors were not able to demonstrate that there was someone on the board that was qualified to take on the fund's risk oversight function and was indeed fulfilling his or her duties as required.

Therefore the survey asked managers if they believe that there are sufficient numbers of qualified people available to serve on boards of regulated AIFs, in a risk supervisory role, in the jurisdiction where their funds are based. If not the survey asked managers whether they considered this to be serious problem. 85% of respondents said that they do not believe that there are sufficient numbers of people to serve on AIF boards in a risk supervisory role. (All hedge fund managers said that there are not enough.)



Selected comments:

"There is a huge shortage of qualified people"

"It is a problem that needs to be addressed"

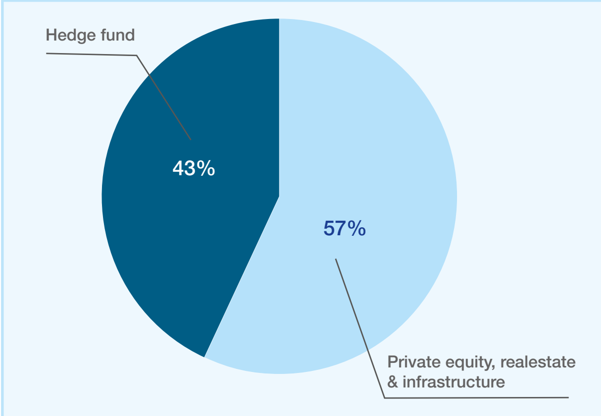
"This is a very serious problem"

"Residency requirements for directors (of regulated AIFs) need to be more flexible"

"In my view this is a major challenge for many directors"

US

IFI Global interviewed US alternative managers with a combined AUM of $306 bn.



Summary

- US managers' views and attitudes towards the European market have changed little as a result of the introduction of AIFMD. US managers still take an opportunistic, investor-led approach to Europe. No one interviewed said that they will withdraw from Europe as a result of the Directive's more onerous Directive provisions.
- Nor has the introduction of AIFMD led any US manager surveyed to expand their European operations. No US manager that is based in the US (as opposed to those with well-established operations in Europe) sees AIFMD as opportunity to passport funds across the EU.
- US managers will become AIFMD compliant if they believe there are sufficient investors there to make this worthwhile. For many interviewees AIFMD has raised the bar on what sufficient numbers of investors are – but it has not put them off altogether.
- Third party AIFMD compliant ManCo platforms are being considered by significant numbers of US managers across each of the alternative asset classes. This appears to be an increasingly popular option for US managers interested in more than one or two European markets (which they are accessing via private placement).
- IFI Global researchers found no managers within the US itself (as opposed to those with offices in Europe) with the technical knowledge of AIFMD to answer the questions on risk, reporting, depositaries or valuation.
- If US managers are aware of one feature of AIFMD it is the Directive's remuneration disclosure provisions. Its unpopularity could reduce the number of US managers entering the European market although this survey has no actual evidence of that occurring. But it has plenty of evidence of complaints on this topic.

Summary

- US managers surveyed are consulting widely on AIFMD. In particular they are taking the advice from their lawyers on what to do. Their views are largely governed by assessments that have been provided to them by their lawyers and in some cases consultants.
- The majority of US managers that were contacted for this survey said Europe is not of interest to them at present – but this has nothing to do with AIFMD.
- Regulatory costs incurred by AIFMD, however, are an issue for many of those surveyed. One interviewee said it is looking to access Germany's private placement regime but the costs are so prohibitive for what is a relatively small fund that they may well not go ahead.

The passport extension issue

US managers were asked what AIFMD might mean for their European distribution plans. For example if the third country passport is made available for US managers, would they consider becoming AIFMD compliant?

No US manager surveyed said that they would have been an early adopter of the passport if the US had gained access to it in July. (ESMA's advice was not to recommend the passport extension to US managers.) So this was a moot point.

But US survey responses revealed surprise and some annoyance that ESMA decided against the passport extension to the US in July. Some interviewees said that this must have been a political decision. Respondents thought that ESMA didn't understand the difference between the US retail and institutional fund markets, given that the US permits EU managers to market funds to institutions on a level playing field with their own managers.

Selected comments:

"We would need to have plenty of evidence before even contemplating it"

"Our interest in Europe is unlikely to widen enough to make this worthwhile"

Private placement, passport & reverse solicitation

US managers were asked for their views private placement and reverse solicitation as well as the AIFM passport.

Only one respondent said his firm was using reverse solicitation. And this was for a specific one off situation. He said he is aware of the dangers of reverse solicitation in general. Otherwise all those surveyed with knowledge of this topic said that they had been warned off using reverse solicitation.

Private placement is overwhelmingly the preferred option. Almost all managers surveyed are focussing on just one or two EU markets only, where they have existing relationships. No one interviewed is planning a pan European push (that is US based) outside those looking at using ManCo platforms.

Selected comments:

"We are looking at the best way to do this just for one country only"

"Our lawyers told us that we would be crazy to even think about using reverse solicitation"

Remuneration disclosure

AIFMD's remuneration disclosure requirements are a real problem for all US survey respondents that are aware of what they entail. A number of survey respondents made the point that they are used to running funds where their interests are aligned with their shareholders because they have their own money invested. Having regulators involved in remuneration matters in their own funds is viewed as being "un-American," said one interviewee.

If there is one aspect of AIFMD that might deter US managers (other than costs) it is the remuneration disclosure provisions. These are alien to American managers.

Selected comments:

"I cannot see what the purpose of this is"

"That Europe could come up with that shows the differences that exist between us"

"This will deter the most successful from engaging with this process ……. they have better things to do"

Domiciliation

US interviewees were asked for their views on fund jurisdictions for AIFMD – both those in the EU (Ireland, Luxembourg and Malta) and those offshore with AIFMD parallel regimes (such as Cayman, Guernsey or Jersey).

Ireland and Luxembourg are the two jurisdictions managers surveyed are using for ManCo platforms. All those interviewed are talking with organisations based in these two locations for this purpose.

Cayman is used by the overwhelming majority of survey respondents for offshore fund domiciliation. Those accessing the EU via private placement are very likely to have funds based in Cayman.

No one surveyed in the US has yet considered using AIFMD parallel regimes in Guernsey or Jersey (even though ESMA has recommended the passport extension to the Channel Islands).

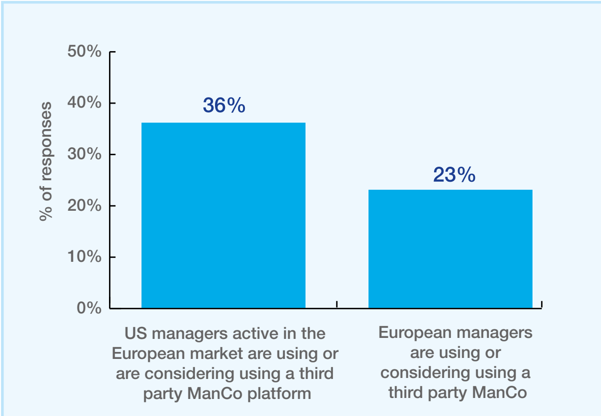
ManCo platforms

Managers were asked about AIFM third party ManCo platforms in some detail. These entities have been developing at a considerable rate in Dublin and Luxembourg but they are also growing in London and Malta.

36% of the US managers surveyed that are active in the European market are using or are considering using a third party ManCo platform.

23% of European managers are using or are considering using a third party ManCo platform in Dublin or Luxembourg.

Managers surveyed listed the benefits and drawbacks of using a third party external ManCo platform for their funds, vis-à-vis alternative options.



ManCo platforms

European responses

(In approximate number of mentions)

Benefits:

- One stop shop attraction
- Avoiding one's own management costs
- Being able to draw on an established team with experience of AIFMD, good processes, continuity etc
- Risk management capability
- Good option for smaller and medium sized managers

Drawbacks:

- Loss of control
- There is a potential for conflicts of interest (on some platforms)
- Pricing (is the ManCo aligned to the performance of the fund that they are managing?)

Managers using these platforms were asked if investors do due diligence on their ManCo providers.

Everyone that responded to this question said yes. In particular they are looking into: experience, ability of staff, principles of the business, funding (cost-structure), systems they use, business continuity, corporate governance, audits/financial review, how often do the boards meet, compliance and other regulatory requirement issues.

Comments on ManCo platforms by European respondents:

- The risk management capability of the ManCo is the most critical factor
- These platforms need to make sure that they get the right balance between flexibility and control
- The majority of the board should be independent
- Some respondents say that those ManCo providers that offer add on services, like cap intro, are failing to deliver

ManCo platforms

US responses

US managers were also asked to list the benefits and drawbacks of using a third party external ManCo platforms for their funds, vis-à-vis alternative options?

(In approximate number of mentions)

Benefits:

- Relying upon the skills and expertise of organisations with AIFMD technical experience
- Leveraging off established market providers located in the EU (Dublin and Luxembourg)
- One stop shop for all AIFMD requirements
- Cost competitive vis-à-vis the other options
- Help with distribution/add on services

Drawbacks:

- Governance of a fund on a ManCo platform: who is ultimately responsible?
- US managers are used to making their own decisions; they are not comfortable ceding control to third parties
- Lawyers see potential problems

ManCo platforms

Combined European & US responses

How important are the following to your organisation when looking to find a ManCo platform provider:

	US	Europe
Other managers on the platform	6.7	4.6
The skill sets of the staff at the platform provider	5.8	6
The resources & technology of platform provider	6.6	4.4
The size of the platform	7.3	3
Fees and fee structure	5.5	6.2
Experience	7.8	6.6

US and European managers were asked if they have a preference for ManCo provider with a background from a particular industry sector (for example one that also offers administration, fiduciary or consulting services)?

In order of mentions:

US	Europe
No preference	No preference
Fiduciary services	Administration
Administration	Fiduciary services
Consulting services	Consulting services

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For more information please go to:
http://www.ifiglobal.com

IFI Global Ltd
10 Arthur Street
London, EC4R 9AY
United Kingdom

Tel +**44 (0)207 220 9077**