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AIFMD Depository Models 2014

**Understanding the
role of the AIFMD-
led depository**

**Ability to offer
flexibility and
independence key**

**Challenges of
assessing AIFMD
requirements**

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Ability to offer flexibility and independence under AIFMD

Interview with David O’Keeffe

SuMi TRUST Global Asset Services provides sophisticated fund administration and custody services in the UK and Ireland and is backed by Sumitomo Mitsui Trust Bank Ltd (SMTB), the largest Trust Bank in Asia with over USD3tn in assets under custody.

David O’Keeffe is the CEO of SMT Trustees (Ireland) Limited, the Irish Trustee/Custodian company. He notes that with SMTB’s A+ rating by Standard & Poor’s, a custodial network that extends into 100-plus markets, and the strength of a considerable balance sheet, SuMi TRUST can support alternative investment fund managers as they clamber to appoint a depository – either in an offshore or onshore capacity – under the Alternative Investment Fund Manager Directive (AIFMD).

Indeed, at the heart of its offering is the ability for SMT Trustees (Ireland) to give managers a degree of flexibility and independence that distinguish it from other depositories.

“We have near 20 years’ experience providing custody and trustee services, servicing both onshore European (UCITS and non-UCITS funds) and offshore funds such as Cayman funds through our subsidiary in Cayman. Consequently, AIFMD requirements are very close to what we already do when servicing UCITS funds in terms of providing depository services; it is the UCITS equivalent for alternative investment funds so our AIFMD solution will be very similar to what we already do for UCITS funds, especially with regards to the oversight function,” says O’Keeffe.

“We look to assist offshore funds to be able to continue to market to EU investors by providing the required key duties of a



David O’Keeffe, CEO of SMT Trustees (Ireland) Limited

depository and to do as much of the heavy lifting for them in the process that we can. We can offer full depository services for managers who have funds onshore or, for their offshore funds, we can perform just one, two or all three of the key duties of a depository. That distinguishes us from a lot of the other depositories.”

Under AIFMD for an EU domiciled fund, the AIFM will need to arrange for the appointment of a single depository to carry out three key duties: cash flow monitoring, the safekeeping of assets, and general oversight. This single depository is also subject to a near strict liability for the loss of financial assets in their custody. However, for a non-EU domiciled fund intended to be marketed to EU investors, these same key duties are still required but the AIFM can appoint “one or more entities” to carry them out.

This flexibility in combining delegates where they can be appointed to carry out one or all of the three duties can assist in maintaining the existing relationship of the AIFM with their prime broker(s) and the fund administrator. For example one popular combination may be where the oversight role is undertaken by the depository, and the AIFM could then look to appoint their prime broker(s) to undertake the safekeeping duty leaving the cash flow monitoring to the administrator. This flexibility, coupled with a lower standard of depository liability is often referred to as a ‘depository lite’ model.

“A lot of depositories want to perform all three key duties for the manager under AIFMD but our aim is to be flexible wherever possible in meeting the needs of the manager. We are content to simply undertake



the oversight duty alone if that's what the manager wants. However, if they want us to safekeep the fund's assets including record keeping which is a part of that duty, with or without cash flow monitoring, we will of course be delighted to assist in that regard; and we will do as much or as little as the manager needs. In fact we have clients appointing us for both models," confirms O'Keeffe.

This is important because not all AIFMs will necessarily want all of their counterparty risk to be concentrated with one service provider. Whilst there are cost benefits to the manager, investors may not look favourably if there is a perceived lack of independent verification, particularly with respect to cash management and general oversight of the fund.

"It's also not simply a case of managers wanting to know about the quality and integrity of the appointed depository but their investors are also interested; they want to know who is behind all this, who is looking after their interests? We work with a number of fund administrators independent of the SMTB group of companies, even though we have our own fund administration arm (SMT Fund Services (Ireland) Ltd). The fact that we have worked successfully with other administrators in direct competition with our own, highlights the level of independence we can bring to the AIFMs product offering."

AIFMs have the choice of appointing SMT

Trustees (Ireland) for any combination, if not for all, of the key duties of a depository in a depo-lite solution. It's worth pointing out that for those managers who run offshore funds, the only additional cost involved may be limited to the appointment of an independent depository to perform the oversight function should the existing service providers absorb the remaining duties into their current costs; that is scheduled to last until after 2015, at which point it remains to be seen whether ESMA will insist on the AIFM having a single depository to undertake all the duties similar to the onshore model. The location of the depository may also become an issue as there may be a requirement to have the depository located in the same jurisdiction as the AIFM or the AIF itself. Nevertheless, SuMi TRUST is well positioned.

"This is something we can future-proof as we have related companies in various locations including Dublin, London, Luxembourg and Cayman," says O'Keeffe.

With managers keen to get clarification from their service providers on precisely what they will or will not support under AIFMD, SMT Trustees is confident that its strong governance, flexibility and level of independence will go a long way to reassuring both clients and investors alike." This is about establishing long-term relationships with managers," states O'Keeffe. ■



Understanding the role of the depository under AIFMD

By James Williams

The Alternative Investment Fund Managers Directive (AIFMD) has many moving parts for alternative investment fund managers to get their heads around. But perhaps one of the most salient issues they face – particularly managers running offshore funds – is the requirement to appoint a depository.

The vast majority of hedge fund managers have never had to do this before and whilst much of the dust has settled in terms of cost impact, there are still a lot of operational and practical details that managers are looking to get answers for.

At the heart of this is determining the type of depository models available.

To briefly summarise, any AIFM running an EU-based AIF will require a full depository solution under AIFMD to carry out three core duties under Article 21 of the directive: namely cash management, safekeeping of assets and general oversight of the AIF.

Such a depository agreement will need to be in place by this summer. For AIFMs running non-EU funds (i.e. Caribbean-based hedge funds) they can appoint one or more entities to carry out these same duties in what is referred to as a ‘depo lite’ solution whereby the appointed offshore depository does not have near strict liability for the loss of any assets in the AIF.

This has the benefit to managers in that they will be able to maintain their existing counterparty relationships with their prime broker(s) and administrator. Under full AIFMD, depositories will vary on the extent to which managers can maintain these counterparty relationships as they will need to assess the risks involved in meeting near strict liability.

“After 2015 ESMA will opine on whether it will insist on a single depository being used, inclusive of the near strict liability for the loss

of financial assets in custody, which applies at present only to EU domiciled AIFMD-compliant funds.

“We also anticipate ESMA will determine where the location of the depository will have to be: either where the AIFM is located or where the fund is located,” comments David O’Keeffe, CEO at SMT Trustees (Ireland) Limited, part of SuMi TRUST Global Asset Services, who continues:

“In the offshore world, if we are only providing the independent oversight function it doesn’t matter as much how many prime brokers are involved because we are not exposed to the same level of risk and more specifically in respect to the near strict liability for the loss of financial assets. Where other existing service providers may absorb any incremental costs to undertake some of the duties of a depository often the only extra cost to the manager using a ‘depo lite solution’ is the oversight function that an independent depository may be appointed to undertake.”

“We offer both onshore and offshore depository services for alternative fund managers. We can support both the integrated and open architecture models under the full AIFMD requirements as well as the depo lite model for offshore funds,” adds Gavin Byrnes, Head of Business Development, UBS Fund Services in London.

Integration versus open architecture under AIFMD

AIFMs will have two models to choose from: either a fully integrated model where the appointed depository acts as the sole counterparty (providing prime brokerage, fund administration and custodian services) or a de-coupled model which will allow them to maintain existing prime brokerage relationships.

Deutsche Bank will support both models. After all, it isn’t feasible for larger managers to move lock, stock and barrel into a single counterparty relationship under AIFMD – one could argue that the concentration risk that would create would be counter intuitive to the directive’s aim of better protecting investors.

However, there are many benefits to the integrated model and it is something that Deutsche Bank, and others, are keen to provide.



“Our model is very much the integrated approach where we can provide all the post trade services a manager might need under AIFMD and has thus far been well received by fund managers. Certainly for new managers, being able to choose an integrated model is an attractive proposition. For larger managers with well developed infrastructures in place, the menu model where managers can pick and choose services also works very well,” explains Mike Hughes, Global Head of Fund Services at Deutsche Bank.

This de-coupled model is where a firm like Deutsche Bank provides everything from prime brokerage, fund administration, depository, cash management, investor reporting and investor services: managers can pick and choose which services they require, which under depo lite, for example, might be for Deutsche Bank to be appointed purely to provide the oversight function.

One of the major benefits to managers who use the integrated model is cost. As mentioned earlier, the onshore depository will be on the hook for any liabilities suffered in the AIF as a result of asset misappropriation. This means that the depository will have to conduct a robust risk assessment of the AIF if the AIFM chooses to continue using multiple prime brokers and the cost impact to the manager will be higher.

“The most important thing for a depository to consider is the counterparties attached to the AIF,” explains Hughes.



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Challenges and considerations of depository requirements under AIFMD

By Gavin Byrnes

Introduction

The Alternative Investment Fund Managers Directive ("AIFMD") has caused much rancour and debate over the last few years but at last the end is in sight. Some of the more challenging aspects of the Directive have centred on the Remuneration and Depository provisions which the industry as a whole has struggled to understand and establish within their businesses. Below are some of the practical challenges and considerations that managers should already be addressing pertaining to their Depository arrangements; in particular Article 21 of the Directive, which is still a provision where managers face complex challenges.

Strict liability

Strict liability has been the most contentious aspect of Article 21 under the Directive; all managers should be engaging with their Prime Brokers and Depositories to develop a workable framework. Although much of the Prime Brokerage industry is accepting a discharge of liability, the argument for demonstrating an objective reason to support such a discharge needs to be carefully considered.

Some Depositories are driving their clients towards a vertically integrated model with their own Prime Broker providing the necessary financing while others appreciate that an open architecture approach is required to ensure costs are minimised and managers can diversify counterparty risk. Services such as financing, risk reporting and other prime brokerage orientated



Gavin Byrnes, Head of Business Development, UBS Fund Services London

ancillary services form the basis of this objective reasoning as without them it is difficult, if not impossible, for a hedge fund manager to operate. Separating the assets from the Prime Broker with Depositories will only further exacerbate the issue and contribute to increased operational cost, technology and integration difficulties as well as increased financing costs.

The other measure being considered to address the strict liability issue is the indemnity model between a Depository and a Prime Broker. Most Depositories who will consider appointing a Prime Broker as a sub-custodian will favour the discharge of liability model but there may be instances whereby this is not possible and an indemnity framework will be the only other option with the exception of placing all long assets with the Depository. Regardless of the model implemented, it is of paramount importance that managers are forcing this discussion with their Depositories and Prime Brokers. Without a deep level of engagement, the manager's ability to run their business and mitigate any significant negative consequences will be difficult to achieve.

Asset segregation

The industry post-Lehman has already moved to address the counterparty risk imbalances that existed in the system. This has led to the development of Custodians offering Prime Custody type solutions or Prime Brokers offering a model where unencumbered assets are separated from the primary margin accounts. The

Directive has further addressed this aspect of the debate whereby any delegate of the Depository must segregate the assets of the Depository's clients from its own assets and from the assets of the Depository in such a way that they can at any time be clearly identified as belonging to clients of a particular Depository. This has caused much debate as to the levels of segregation with some Depository participants determining that it is virtually impossible to ensure such segregation without holding the assets within their own sub-custody network.

This approach is quite conservative with a more balanced argument being that the Depository must at all times be able to "identify" these assets. Many Prime Brokers in the UK today already implement an equivalent requirement under the Financial Conduct Authority (FCA) CASS Rules and the argument here is that the identification process is a record-keeping and reconciliation requirement rather than a finite asset segregation requirement all the way to the underlying delegate of the prime broker. Either way, Depositories have different views on how this arrangement should be implemented and it is critical that managers ensure that this particular aspect is addressed at the earliest possible stage.

Oversight duties

The oversight duties under the Depository framework are very similar to the Irish trustee model which has been the prevalent framework in place for the Qualified Investor Fund (QIF) regime, now called the Qualified Investor Alternative Investment Fund (QIAIF) under the Central Bank of Ireland AIF rulebook. This is more of a fiduciary role whereby the Depository must oversee all the activities of an AIF and ensure that they fulfil all the requirements as set out under the Directive. It is important that all managers address the requirements as this could impact the day to day operations of their business.

Each Depository will have a different set of standards to fulfil their obligations and managers that work with more than one Depository may find themselves in a situation whereby they are supporting multiple reporting requirements further complicating their business. The smaller the manager the more important it is that they engage with their Depository and fully understand how this may impact their day to day operations.

Cash Flow monitoring

Cash Flow monitoring is an extremely challenging aspect of the Directive for Depositories who have struggled to determine how they can implement an operating framework to support this requirement

especially where a prime broker has been appointed as a sub-custodian. There have been arguments put forward that the cash flow monitoring requirements will force managers to implement vertically integrated models (i.e. appoint an Administrator and Depository from within the same group).

The argument is that the Depository can rely on the reconciliation procedures in place with the administrator to support its verification of all cash flows within the AIF. To rely upon an independent Administrator from outside the same group as a Depository would be a risk that many Depositories may not be willing to bear. This has led to much debate and it is important that managers are discussing with Depositories what their framework is to support the cash flow monitoring requirement and whether they can work with a third party Administrator.

Depository "Lite"

The Depository Lite regime is actually the most pressing aspect under the Directive as the impact is far wider given the number of offshore funds managed by European managers as compared to European funds. The central difference with the lighter regime is that the strict liability standard does not apply and in certain instances the core functions as outlined above can be performed by one or more entities (this is the position taken by the FCA in the UK).

The same practical challenges exist but more relating to the cash flow monitoring requirement given that the majority of Prime Brokers will act as the custodian of the assets with most receiving the necessary licenses to fulfil this function. It is important that managers fully understand the oversight requirements as this will be a new concept for offshore funds in general. It is also very important that the cash flow monitoring can be arranged in a way that satisfies the Depository should a third party act as the Administrator.

Conclusion

It is clear that a single approach across each and every manager will be difficult to achieve. The industry needs the support of the Depository and Prime Brokerage community to work with managers and find a model that best fits the needs of their business while also ensuring that all aspects of the Directive can be fulfilled.

Whether this will lead to a vertically integrated or an open architecture approach is yet to be seen. We are confident that an open architecture model is the most sensible approach and one that will ensure the ability of our clients to manage money while ensuring that costs are in some way mitigated for shareholders. ■

7 ▶ “With the integrated model, a lot of the risk can be internalised and the cost impact to the manager is reduced. Where external prime brokers are being used we need to determine: who is the counterparty? Which legal entity is involved? What markets are they trading? What is the registration process in the underlying market? What is the legal position of the fund’s assets and how are they held in the local market?”

“When determining risk it is done by fund, by strategy and ultimately by understanding who are the counterparties to the fund.”

O’Keeffe notes that from a cost perspective it’s likely to be a smaller impact on the managers’ fund performance when choosing SMT Trustees either for full AIFMD support or depo lite when compared to what many thought pricing might be only 9-12 months ago: “There will be more work involved for us with respect to cash flow monitoring in particular under AIFMD but nothing that will involve exorbitant costs to the manager. If a fund is delivering good returns, a small increase in terms of a few basis points shouldn’t have too much of an impact on a performing fund.”

Ultimately the cost impact to the manager will depend on the strategy and the type of assets being traded, and in which markets. In the fully integrated model the risk premium will be lower compared to the de-coupled model. When asked whether Deutsche Bank would ever refuse to support a manager if the perceived risks being taken in the AIF were too high, Hughes replies:

“Where we would take a view on the manager is where they are trading frontier markets, for example, and holding assets with prime brokers who are not approved on our platform. In such a scenario we might not be able to provide depository services for those specific markets.

“Illiquid assets like hedge fund side-pockets, real estate assets etc are strategies that are supported provided we can get comfortable with how they are held by the fund. It comes down to: what is the asset, where is it held, and who are the counterparties. That will determine the yes or no decision tree.”

As part of its oversight function to ensure a fund is trading within its investment guidelines Deutsche Bank has built a



technology solution called dbDepository that monitors and controls the three core functions under AIFMD: oversight, safekeeping and cash flow.

“If all of a sudden on a Monday morning a frontier market appears in the asset base, and it’s meant to be a developed market LSE strategy, and where the manager has started using a custodian that we don’t have tagged against that particular manager, it will be flagged up as an exception. We’ll open up a dialogue with the manager to determine why it has happened,” says Hughes.

The open architecture model

At UBS Fund Services, the integrated model is fully supported to those AIFMs who would prefer to go that route but such a model will not necessarily be in the best interests of managers of a certain size who will benefit more from an open architecture model, says Byrnes. In his view, it makes sense to allow the manager to continue with the existing prime brokerage relationships, provided of course the prime brokers are supported on the UBS platform.

“We can facilitate an open architecture platform for prime brokerage appointments. This gives clients the flexibility to appoint the prime brokerage counterparts they need to work with which will add significant value to their business and that of their shareholders,” says Byrnes.

The open architecture approach is

▶ 14

Determining the veracity of assets is a core requirement

Interview with Roger Woolman

Both depositories and fund administrators face huge demands from a data management perspective under the AIFM Directive. For any depository appointed by an AIFM running an onshore hedge fund, the scope of responsibility is greater than that required under a depository lite scenario for AIFMs running non-EU funds. This is because of the strict liability placed on the depository to return assets to the AIF in the event that something unforeseen happens and assets are lost.

Combined, the depository to an alternative investment fund (AIF) will have three core tasks to perform safekeeping of assets, cash monitoring, and general operational oversight of the AIF. Hence the need for reliable data to support a depository's compliance workflow, especially if the AIFM continues to use existing multi-prime brokerage relationships.

Unsurprisingly, Advent has long been ahead of the curve and is well placed to support depositories under AIFMD with respect to asset verification. With Advent Data Services (ADS), what the firm has done is effectively reinvent its counterparty network to enhance the regulatory compliance demands depositories (and other service providers) now find themselves under.

"Through Advent Data Services, we offer the industry's largest and fastest growing network of counterparty connections for detailed position and transaction information. Through this service, we provide clients with a single normalised data feed so they can quickly and easily access detailed information across



Roger Woolman, senior solutions consultant at Advent Software

counterparties that is critical to addressing the AIFMD directive. Clients use this data not only in support of AIFMD specifically, but also to address broader regulatory and asset verification related initiatives. In addition we have well-established portfolio management products such as Advent Geneva, which performs data aggregation at the position level for reporting," explains Roger Woolman, senior solutions consultant at Advent.

A bespoke compliance dashboard where the depository would be able to check the asset (as part of their oversight function) against the fund mandate can be facilitated using existing dashboards and monitoring tools within Advent Geneva.

There are three main areas for depositories to focus on under AIFMD: data collection and aggregation, compliance, and reporting.

"AIFMD is designed to protect investors from fraud so a depository has to determine not only that various assets are aggregated and monitored but also to identify assets that might be excluded.

"It's not therefore a question of having to aggregate all assets as there will be contractual agreements in place with prime brokers," says Woolman.

The depository will be required to collect various levels of data such as:

- Assets
- Custodian
- Collateral
- Rehypothecation data
- Fund mandate

Ultimately, asset verification by aggregating data from various sources is aimed at

ensuring where a fund's assets are held and who owns them.

Compliance is another important aspect. A fund's mandate might prevent exposure to certain instruments. The depository will need to make sure in its oversight function that the manager doesn't try and work around that mandate by using swaps, or some other form of instrument, that are prohibited in the mandate.

"The third element is reporting to the authorities. Classifications schemes may or may not vary i.e. the Dutch insist on a specific classification of securities but the UK may have a different classification scheme requirement. You could add a fourth element. This relates to insurance which the manager pays to the depository to ensure that the fund's assets are replaced in the event that something goes wrong," adds Woolman.

ADS, in tandem with Advent Geneva, is a two-pronged approach to verify the assets and effectively aggregate data pertaining to those assets for reporting purposes.

"Geneva has always been very strong at tracking exposure of the underlying assets. It has broad asset coverage and can track exposure to underliers on swaps and other such contracts to support look-through reporting capabilities. The ability to configure a bespoke dashboard under AIFMD, to make this more user-friendly, can be implemented. We already have other dashboards for verifying rules and limits, post-trade compliance etc."

The ADS solution gives Advent secure hub capabilities for processing what is expected to be a deluge of data for AIFMD in both the US and Europe. "It offers two-way connectivity and communication," says Woolman, who describes ADS in layman's terms as a "global platform for firms to receive and disseminate all asset and portfolio-related information".

The benefit to depositories who use ADS is that Advent is a neutral party that offers complete independence in handling and maintaining data, as well as looking at new ways to improve and expand upon the number of data providers and scope of data. It already uses 800-plus data providers.

Woolman explains that ADS is part of a new thrust by Advent under its cloud-based holistic framework called Advent Direct. This

framework brings the three key tenets of data management, workflow management and reporting together, in so doing allowing end-users to respond to any form of regulation; not just AIFMD but Dodd-Frank in the US, EMIR reporting in Europe etc.

"I think the message for us is that Advent is transitioning away from a modular approach and moving towards more innovative ways to deliver integrated user-centric workflow solutions that are easy to adopt and use.

"All our services will come out of the Advent Direct cloud-based platform. What services a client uses will simply depend on who they are as a firm. When we talk about our different solutions, in the future we will not think of them as distinct modules - rather as part of the Advent ecosystem.

"If a depository comes to us for a depository service under Advent Direct it's a case of saying to them, 'What portions of [the depository function] do you want to fulfil? Then the consideration becomes which services to avail of within our overall Advent Direct offering," explains Woolman.

This will allow for a more intuitive approach; one that will allow depositories to be much more flexible in their ability to support both onshore AIFs under full AIFMD and offshore AIFs under a 'depo lite' solution.

ADS has started to attract strong interest from depositories. Woolman confirms that a large deal was signed last year and that a number of deals are currently in the pipeline as service providers begin to fall into line under AIFMD.

"Interest from existing clients is very high. If you can't do this (support AIFMD) it'll make you less competitive. Clients need to verify the assets, consolidate data for reporting. They want notification of cash movements. So there are a number of different layers to AIFMD. As a vendor, we've got to support these functions in different places: verification and consolidation of assets in ADS, Advent Geneva for the compliance and monitoring function.

"Ultimately, depositories will have the option of using Advent Direct for as much or as little support as required depending on which roles they need to perform under AIFMD," concludes Woolman. ■



11 ► considered by UBS to be a more cost-effective framework to implement. UBS will work with a manager's preferred prime broker(s) in order to implement a legal and operational framework commensurate with the framework it has in place in the UBS investment bank division.

"This framework is in line with other open architecture frameworks with respect to discharge of liability (to the prime broker under a sub-custodial agreement). Where that is not possible we will have an indemnification model in place with the relevant prime broker.

"We therefore don't envisage that this model is going to be as costly as some of the headlines have predicted over the last 18 months. We think the costs are going to be negligible relative to the pre-AIFMD framework that has been in place in Ireland for Irish QIFs," says Byrnes.

Provided the discharge of liability is acceptable to both the AIFM, the depository and the prime broker - who will under such an arrangement be responsible for the safekeeping of the fund's assets (less unencumbered assets) - and the necessary disclosures are made, Byrnes sees this open architecture model as the one most likely to be adopted by the industry.

"In the event that model is not possible for whatever reason, and one needs to move to an indemnification model in terms of the depository managing its liability that will have a marginal cost impact to the manager but nothing too prohibitive compared to what they pay today. If, however, both prime brokers agree to the discharge of liability model then it will not be significantly cost

prohibitive to the manager than the pre-existing Irish trustee framework for QIFs," explains Byrnes.

Whether a manager chooses the integrated model or the open architecture model will largely depend on their size, whether they are a new or existing manager and the extent to which they use prime brokers.

One issue that managers were initially concerned about was how the appointment of a depository under AIFMD might impact their prime brokerage relationships. This though is very much a ship that has sailed thanks to the sub-custodial agreements for discharge of liability that are busy being put in place. What is of more concern is making sure that their depository will actually support their preferred prime broker(s).

"If managers don't get on top of this soon they could find themselves in a situation where all their balances will have to be transferred to one particular prime broker if the other prime brokers they are using are not supported by the depository.

"We are looking to add more counterparts to our platform. This will develop over time and it'll be the same for every depository operating under an open architecture approach," says Byrnes.

With respect to the oversight of other assets (i.e. those held by the prime broker) and the custody of bankable assets, a depository has a duty under AIFMD to ensure those assets are ring fenced and to ensure that the AIF has restitution of such assets upon the failure of any particular counterpart.

"We are not looking to intervene in the ► 16

Regulatory ERM solution to support Annex IV

Interview with Gary Kaminsky

ConceptONE LLC specialises in regulatory and risk reporting, an area of expertise that is fast gaining prominence as alternative fund managers begin to comprehend the enormity of regulatory compliance.

“We have developed a regulatory enterprise risk management solution – RegERMTM – specifically to meet the regulatory reporting challenge,” states Gary Kaminsky, Managing Director, Global Regulatory & Compliance at ConceptONE.

“It’s a holistic system because regulatory reporting now comes in many forms: not just Annex IV reporting under AIFMD, but Forms PF and CPO-PQR under Dodd Frank and EMIR and ESMA short selling.”

Annex IV reporting shares certain data with Form PF in the US but the level of complexity is arguably higher.

A legal regulatory skill set is needed to complete the form, something that Kaminsky is well experienced in having formerly worked as an SEC enforcement attorney, but in-depth knowledge of hedge fund risk and operations management is something that Kaminsky and the ConceptONE team also bring to the table.

“Aside from having a multi-disciplined team you also need to have the right combination of systems. It’s partly data aggregation, partly data warehousing and it’s partly a technology solution for the actual reporting element,” says Kaminsky.

What ConceptONE’s solution does is to aggregate data from various sources into a centralised warehouse. Technology engines then normalise the data and enrich it for population into regulatory reports. ConceptONE’s task is to enable clients to achieve at least three reporting goals:

Firstly, that the filing is not “incorrect”. While there may be no correct answers to the questions, there can be incorrect ones,



Gary Kaminsky, Managing Director, Global Regulatory & Compliance at ConceptONE

namely inconsistent, disparate reporting. Managers will want to guard against data and analytics used in Form PF deviating from what they report in Annex IV. Second, says Kaminsky, it’s about trying to create a repeatable process so that each time a manager files it doesn’t have to reinvent the wheel and require the firm’s compliance and operations group to shut down to complete the task

“This is comprehensive reporting that involves sharing sensitive information and it takes a lot of time to aggregate the requisite data. A manager doesn’t want to have to do that every time they file. Regarding Annex IV, it could be that the manager has to file twice or four times a year depending on how big they are. And EMIR reporting is daily. So you need a repeatable process.

“Third, and maybe most importantly, you need an audit trail. Ultimately, somebody is going to ask why something was reported in a certain way (regulator or investor), these queries may take place months or years after the filing and if the manager can’t explain their approach, they could end up being the subject of a long investigation by the regulator,” comments Kaminsky.

There are thousands of data points involved in regulatory reporting. What ConceptONE’s solution does under Annex IV, which contains approximately 60 questions and thousands of data sets, is break the data points down into 18 proprietary data sets. The solution then finds the data needed to populate each of those data sets.

“This is a very large data management exercise involving disparate sources. Although it’s not rocket science doing these reports, it’s about how much time and resources a fund manager wants to give up – better to take advantage of experts like ConceptONE.” ■

HOW TECHNOLOGY IS HELPING DELIVER SOLUTIONS TO AIFMS

Advent is one of the world's leading financial software companies. At the heart of the firm is the expertise its systems offer to fund administrators, prime brokers and depositories (as well as managers themselves) with respect to data management. Under AIFMD, the volume of data and complexity of workflows will, for depositories in particular, rise substantially. And with Annex IV likely to present more of a reporting challenge than Form PF in the US, fund administrators will need to ensure that the data they use is enriched.

A key drive in helping consolidate work flows has been the roll out of Advent Direct. A cloud-based collaborative platform, it offers the necessary framework to support clients across data management, workflow management and reporting.

In the US, Advent has been busy ramping up its data acquisition capability, referred to as Advent Custodial Data, by connecting to hundreds of brokers and custodians. These data feeds, in conjunction with its own internal systems, are providing its clients with the data they need to support their own clients. And its Advent Direct that is providing that integrated framework.

"The key component of data management as we see it is the ability to normalise the data that all downstream systems could understand. The Advent Direct framework supports data coming from both internal systems and external systems used by banks and custodians, and normalises it.

"We are now busy building out this capability for the European market where clients will be able to leverage the data for whatever their needs. What we've done is help streamline the data management process," comments Martin Engdal, Market Strategist and Director of Solutions Marketing at Advent.

In Europe this is referred to as Advent Data Services and will sit within the Advent Direct framework.

"Through this service, we provide clients with a single normalised data feed so they can quickly and easily access detailed information across counterparties that is critical to addressing the AIFMD. Clients can use this data not only in support of AIFMD specifically, but also to address broader regulatory and asset verification related initiatives. In addition we have well-established portfolio management products such as Advent Geneva, which performs data aggregation at the position level for reporting," explains Roger Woolman, senior solutions consultant at Advent.

The data collected in ADS will be enriched with information on notional values, fees, position-level exposures etc, which will help determine its veracity to support depositories in their cash management and oversight duties under AIFMD.

From a reporting perspective, New York-based ConceptONE LLC, a specialist regulatory reporting and risk management firm, has developed a regulatory enterprise risk management solution known as RegERMTm.

There are thousands of data points involved in regulatory reporting. What ConceptONE's solution does under Annex IV is break the data points down into 18 proprietary data sets. The solution then finds the data needed to populate each of those data sets.

"We then aggregate that data, normalise and enrich it into our proprietary data sets so that our engine can populate each of the individual questions. The engine also does the necessary calculations. Annex IV in particular has a lot of risk and exposure-type calculations that need to be done," confirms Gary Kaminsky, Managing Director, Global Regulatory & Compliance at ConceptONE.

ConceptONE has already filed an Annex IV report for one London-based manager and Kaminsky notes that its solution is not just able to help AIFMs complete the filing but also how it is processed. The European regulator ESMA wants data to be sent in XML protocol, which has been adopted by the FCA in London.

"Translating the answers to questions in Annex IV into XML apparently has been a challenge for some. I read recently that there's a glitch with ESMA's protocol when in fact there is no glitch. The glitch is with those who do not know how to work with XML protocols. We are experts in translating data into XML protocol and we're also able to validate that the XML protocol we use is the one that ESMA and the FCA require," says Kaminsky.

Market participants realise that their institutional asset base is not going to allocate assets to firms that don't have the regulatory infrastructure in place, in Kaminsky's view.

"What people don't necessarily focus on is the consequential benefits that regulation may have by forcing firms to implement regulatory enterprise risk management infrastructure that will minimise the types of lapse that have caused significant loss and regulatory scrutiny recently.

"In order to comply with regulation like AIFMD, managers are going to need to align their front, middle and back offices and create better synergies with third party providers. People talk about the cost of compliance. We talk about the cost of non-compliance."

Integrated and menu-driven model to support AIFMs of all sizes

Interview with Mike Hughes

For the most part a lot of the drama surrounding the role of depositories and prime brokers under AIFMD has subsided. All parties concerned have pretty much fallen into line and are clear with what everyone's roles and responsibilities will be. This is certainly true of Deutsche Bank who are fully AIFMD-compliant and already actively engaged in signing depository agreements with clients.

"We have a model that looks at sole depository services and how that might look in terms of level of reporting, level of due diligence required. We've already taken on board mandates where we act solely as the depository," confirms Mike Hughes, Global Head of Fund Services at Deutsche Bank.

With respect to AIFMs who are running onshore hedge funds (e.g. an Irish QIF) and whom require an onshore depository under the directive, there are various models being offered by service providers. One is the above scenario described by Hughes where the manager maintains their multiple prime brokerage relationships - and potentially even their fund administrator - and appoints Deutsche Bank to purely perform the oversight function, for which the bank will face strict liability in the event of fund asset misappropriation.

At the other end of the spectrum is a fully integrated approach where Deutsche Bank acts as depository, fund administrator and prime broker to the AIF: a single counterparty relationship which minimises frictional cost to the AIF as risk is contained within the same four walls.

"This depository bundle model can include, in our case, the entire value chain of products and services that an asset manager needs from the point of execution



Mike Hughes, Global Head of Fund Services at Deutsche Bank

of a trade through to middle-office services and investor reporting, with depository and administration services on top.

"Deutsche Bank is using these different models and trying to be as flexible as we can. We as a firm have to now take on a lot more liability under AIFMD and we need to work through that, understand that liability, the risk profile of the fund and the different risk premia that go against that new level of liability.

Whether Deutsche Bank merely acts as a sole depository providing the oversight function, provides all three core functions under AIFMD to the manager (these include: cash management and reconciliation, safekeeping of assets and general oversight), or the client opts for a 'menu-driven' arrangement somewhere between the two, will determine the level of risk exposure to the depository, and ultimately the cost to the fund.

Hughes confirms that this needs to be done on a fund by fund basis.

"The most important thing for a depository to consider is the counterparties attached to the investment strategy. Where external non-Deutsche Bank prime brokerage transactions are being used (under the multi-prime model) we need to determine: who is the counterparty? Which legal entity is involved? What markets are they trading? What is the omnibus structure in the underlying market? What is the legal position of the fund's assets and how are they held in the local market?

"Each of the depository banks - and we've gone through an exhaustive list of check points around each local market - has become comfortable with the way assets are held in local markets.

“So when determining risk it is done by fund, by strategy and ultimately by understanding who are the counterparties to the fund,” explains Hughes.

The integrated model that Deutsche Bank has developed to support AIFMs is preferential to the firm precisely because it mitigates risk and obviously provides cost benefits to its clients as compared to a de-coupled model.

Indeed, a white paper written by Deutsche Bank entitled ‘Charting a smooth course through AIFMD implementation’ towards the end of last year clearly stated: “We believe that AIF managers would be best served by consolidating their business with depositories 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.”

Hughes confirms that the model that has been well received by fund managers and notes that for new managers in particular who are launching alternative investment funds, being able to choose an integrated AIFMD model becomes a very attractive proposition.

“Our model is very much the integrated approach where we can provide all the services a manager might need under AIFMD,” says Hughes, who continues:

“However, for larger managers with well developed infrastructures in place, the menu-driven model that we have where they can pick and choose services also works very well. Our principal objective is not to bring any significant change to the market. In that scenario, it’s not feasible for such managers to move lock, stock and barrel to a single counterparty. We completely understand that.”

Being a universal bank, Deutsche Bank has all the functions in place, separated by necessary Chinese walls, to give the AIFM as much or as little support as necessary. One manager might use their fund administration services, one might use them purely for prime brokerage services, whilst another manager might use both in conjunction with depository services to benefit from more of a holistic AIFMD solution.

Ultimately, it will depend on the nature of the manager, but certainly for start-ups, the integrated solution is a compelling one.

Hughes is quick to reassure managers that should they wish to continue to use multi-prime relationships, this won’t adversely affect the way they run their fund. There have been fears that under such a scenario the depository would interfere in the process but a lot of work has been done in terms of agreeing the operational model. This should allow managers to run their fund as per usual.

“We are talking to all the major prime brokers on the street and signing agreements. If a manager comes to us and says, ‘We’d like to appoint you as our depository and we’ve got these four prime brokers’, there should be no drama because we should hopefully already have an agreed operating model in place with each of those primes. If a depository cannot demonstrate that they have these agreements in place with a manager’s preferred prime broker(s) that should be more of a concern than any perceived influence the depository will have,” says Hughes, confirming that Deutsche Bank has made huge strides in signing prime brokerage agreements over the last three months.

As the July deadline fast approaches for London-based managers to become AIFMD-compliant the level of eagerness to have their approved depository contracts in place is building. The level of pressure being applied to service providers to get their ducks in a row has been significant over the last few months. Far from sitting back, managers are actively engaging in the process and pushing everyone to get service agreements in place says Hughes. That Deutsche Bank is able to reassure AIFMs that it can support their AIFMD compliance needs is of strategic importance at a time when some depositories are giving unclear answers.

“We are now starting to see uptake across the board on terms of the type and size of alternative investment fund managers,” confirms Hughes.

“In particular, we are seeing a trend among real estate fund managers. They are being very active in looking for depository solutions.” ■

16 ► day-to-day business of how a hedge fund manager interacts with their prime broker(s). We just want to make sure that in our role as the depository we can put a framework in place that addresses the requirements of Article 21 under the directive and that we can agree a framework with the prime brokers. If we can do that it should have very little impact on the daily operation of a hedge fund manager as long as they themselves are meeting the requirements as an AIFM," adds Byrnes.

O'Keeffe points out that SMT is active in nearly 100 markets and has between 12 and 14 sub-custodial relationships, stressing that "we do not intend to impose our own custody network. If the AIFM has an existing relationship with a prime broker(s) and they wish to have SMT Trustees consider their appointment as a sub-custodian we will of course undertake due diligence etc but as we already have many prime brokers appointed as sub-custodians its also likely to be a faster process.

"We haven't insisted that the assets at the primes are placed back in our own directly appointed custody network. Instead we're happy to consider the appointment of others as sub-custodians. That may assist a lot of fund managers in respect of turnaround time too."

Asset segregation

One issue that has been actively debated among prime brokers and depositories for many months, but which appears to have been resolved centres on asset segregation. From the point of view of some depositories, as part of their oversight function they want full segregation right down to the underlying delegate level of the prime broker. This seems wholly impractical and unlikely to fly. It would interfere with the financing models in place, in particular the ability for a prime to pool clients' assets into an omnibus account for rehypothecation purposes.

"Our view is that as long as the assets can be identified with the underlying delegate and we can identify those assets within our own systems we won't look for asset segregation at the prime broker. We think it is absolutely not achievable. Even for a custodian, having segregation of assets for each and every client is something that

would make the business model impossible," comments Byrnes.

A lot has been written about the ability to support independent prime brokerage relationships under the depository provisions of AIFMD. However, maintaining an independent fund administrator could also prove to be important to managers and their shareholders.

The administrator's role is vital in relation to cash flow monitoring. Unlike the prime brokerage sub-custodial arrangements, however, many depositories will likely prefer AIFMs to avail of both their depository and fund administration services under one roof. Many of the universal banks are well placed to support this. The benefit being that they run daily operating models for cash reconciliation. This data can then be fed directly for review as part of the oversight function. The minute the depository has to work with an independent administrator costs will rise because of the IT impact on aligning systems to handle third party data feeds etc. This will add extra cost to the AIFM.

At SMT Trustees (Ireland), O'Keeffe views the ability to support independent administrators as a useful value proposition: "Who is watching the watchers? Who is truly independent in all of this? We work with a number of fund administrators totally independent of the SMT group, even though we have our own fund administration arm, and provide trustee and custodial services for funds that they act as administrator for.

"They are happy to work with us, there's no conflict of interest. They bring clients to us and we act independently. It works well and it shows clients that there's consistency of understanding. That we work with other administrators in direct competition with us really highlights the level of independence we can bring to the table," says O'Keeffe.

Hughes concludes by saying that the process for managers to appoint Deutsche Bank as their depository is a quick and easy process: "We've got depository agreements that are compliant with each of the major fund jurisdictions – Luxembourg, Ireland, Malta. It's then down to each manager's lawyers reviewing the agreement documentation. So really it's a case of how quickly the AIFM takes, rather than us as the depository, to get the agreement signed and sealed." ■