

<b>Title:</b> Alternative Investors Fund Managers Directive <b>IA No:</b> <b>Lead department or agency:</b> HMT - Financial Services <b>Other departments or agencies:</b> Financial Conduct Authority	<b>Impact Assessment (IA)</b>				
	<b>Date:</b> 19 April 2013				
	<b>Stage:</b> Final				
	<b>Source of intervention:</b> EU				
	<b>Type of measure:</b> Secondary legislation				
<b>Contact for enquiries:</b> Sameen Farouk 0207 270 6038					
<b>Summary: Intervention and Options</b>					<b>RPC Opinion:</b> GREEN

Cost of Preferred (or more likely) Option					
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Two-Out?	Measure qualifies as	
-£6,507m	-£6,493m (£0m in scope)	-£1238m (£0m in scope)	No	N/A	

**What is the problem under consideration? Why is government intervention necessary?**

The UK is required to implement the Alternative Investment Fund Managers Directive (AIFMD) into law by July 2013. AIFMD aims to address the risks:

- Regulatory fragmentation may inhibit the effective regulation, supervision and macro-prudential oversight of alternative fund managers, including hedge fund and private equity fund managers by failing to take account of the cross-border dimension of their activities; and
- Regulatory fragmentation may also impede market integration and the development of the single market by creating barriers to the efficient cross-border distribution of alternative funds.

**What are the policy objectives and the intended effects?**

AIFMD will establish an EU-wide harmonised framework for monitoring and supervising risks posed by Alternative Investment Fund Managers (AIFMs) and the funds they manage (AIFs); and for strengthening the internal market in alternative investment funds. The Directive contains provisions relating to the conduct of business, transparency and marketing, and provides for the cross-border managing and marketing of funds. In implementing the Directive, the Government aims to maintain and enhance UK competitiveness, promote investor choice, and maintain strong investor protection and integrity of the marketplace.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

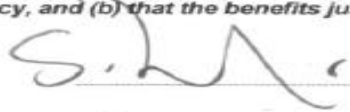
Non-implementation of AIFMD (Option 0) has been discounted as it would be counter to the UK's treaty obligations and deny UK-based managers the right to passport across the EU. AIFMD permits the introduction of a more minimal regime for managers managing funds below a size threshold, though the UK may choose to "level up" requirements:

Option 1- implement AIFMD with maximum gold plating for sub-threshold AIFMs  
 Option 2- implement AIFMD with minimum gold plating for sub-threshold AIFMs  
 Option 3 – implement AIFMD in line with the Government's preferred option for sub-threshold AIFMs – which is maintenance of status quo arrangements. **This is the Government's preferred option.**  
 A further option - Option 4 – is considered, which has the same sub-threshold regime as Option 3 but introduces further deregulation through the removal of retail marketing restrictions.

<b>Will the policy be reviewed?</b> It will be reviewed. <b>If applicable, set review date:</b> July 2018					
Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	<b>Micro</b> Yes	<b>&lt; 20</b> Yes	<b>Small</b> Yes	<b>Medium</b> Yes	<b>Large</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)			<b>Traded:</b> 0		<b>Non-traded:</b> 0

*I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.*

Signed by the responsible Minister:

 Date: 2/6/13

Summary: Analysis & Evidence Policy Option 1

Description: Implement AIFMD with maximum gold plating for sub-threshold AIFMs

FULL ECONOMIC ASSESSMENT

Price Base Year 2009	PV Base Year 2013	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low -11,109	High: -6,576	Best Estimate: -8,843

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	528	1	1,340	6,577
High	673		2,311	11,110
Best Estimate	600		1,826	8,843

**Description and scale of key monetised costs by 'main affected groups'**

Under Option 1, there would be no reduction in directive requirements for managers managing funds below the size threshold. The main affected groups will be asset managers, custodian banks and investors. The fund management industry will face £414m-£541m in one-off costs and £1.3bn-£2.3bn in ongoing costs. Depositories also face £4m in one-off costs and £3m in further ongoing costs. FSA also incur one-off costs of £13.4m. Most costs are assumed to be ultimately absorbed by the investor through fees or lower returns. Costs within the scope of the Government's One-In, Two-Out policy are the costs in introducing new requirements above the directive minimum.

**Other key non-monetised costs by 'main affected groups'**

- (1) Some managers may choose – or be forced – to restructure, imposing costs and reducing flexibility.
- (2) Competitiveness costs for option 1, as other Member States are likely to have more proportionate regimes for hedge fund, venture capital and private equity fund managers in particular. A reduction in the latter two categories in particular could reduce investment in the UK.
- (3) Broader economy may suffer from a reduction in investment and reduced liquidity in financial markets

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low				
High				
Best Estimate				

**Description and scale of key monetised benefits by 'main affected groups'**

Potential benefits have not been quantified. However, the key benefits of the measures will be to monitor and address systemic risk, protect investors and maintain efficient functioning of financial markets.

**Other key non-monetised benefits by 'main affected groups'**

Under option 1, investors benefit from a strong, harmonised level of protection regardless of the size of fund being managed. In the context of the financial crisis and the Madoff fraud, AIFMD supports (1) the ability of regulators to monitor systemic risk and take action as necessary, (2) provide greater protection for investors in alternative funds, (3) the removal of barriers to the cross-EU marketing of alternative funds.

**Key Assumptions/Sensitivities/Risks**

3.5%

1. Population remains stable – no significant restructuring, consolidation or redomiciliation in/out of the UK
2. Assets managed by industry remain stable in real terms – unclear if there are any shifts
3. Cost of compliance staff varies between £80,125-£100,000 depending on type of fund
4. Competitive service providers e.g. prime brokers, depositories, external valuers and fund administration
5. Our broad assumptions about the varying cost of these requirements remain generally robust

**BUSINESS ASSESSMENT (Option 1)**

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs 314	Benefits:	Net: -314	Yes	In

# Summary: Analysis & Evidence

# Policy Option 2

Description: Implement AIFMD with minimum gold plating for sub-threshold AIFMs

## FULL ECONOMIC ASSESSMENT

Price Base Year 2009	PV Base Year 2013	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low: -8,767	High: -4,247	Best Estimate: -6,507

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	245	887	4,247
High	377	1,858	8,766
Best Estimate	311	1,372	6,507

### Description and scale of key monetised costs by 'main affected groups'

Even under *de minimis* approach, the cost of implementing AIFMD are c. 75% of maximalist approach. This is because for above threshold managers, costs are as option 1 as the Government as no discretion over application of AIFMD for this group. FSA costs are also as option 1.

For sub-threshold managers, additional costs would be minimal as the vast majority of AIFMD requirements are disapplied under option 2.

This option is deregulatory. Costs within scope of the Government's One-In, Two-Out policy are zero as no new requirements have been introduced above the Directive minimum. Benefits have not been quantified but have been described qualitatively.

### Other key non-monetised costs by 'main affected groups'

For sub-threshold managers, option 2 is deregulatory – and represents a significant reduction in investor protection as FSA regulatory oversight would largely be withdrawn. This could lead to investor detriment – especially for retail investors – and could reduce confidence in the UK regulatory system and potentially UK competitiveness. For some sub-threshold managers – principally investment companies, which would be new to FSA regulation - option 2 this represents status quo. For above threshold managers, as option 1.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low			
High			
Best Estimate			

### Description and scale of key monetised benefits by 'main affected groups'

Potential benefits have not been quantified although evidence has been presented to support the general policy approach. The key benefits are set out in Option 1

### Other key non-monetised benefits by 'main affected groups'

Option 2 is deregulatory for managers of most sub-threshold funds including hedge funds private equity funds and venture capital funds – reductions in cost in comparison to the current regulatory regime have not been quantified at this stage but will be lower – some savings may well be passed on to investors. It is possible this could make the UK more competitive as a place to manage the funds.

For above threshold managers, as option 1.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
<ol style="list-style-type: none"> <li>Population remains stable – no significant restructuring, consolidation or redomiciliation in/out of the UK</li> <li>Assets managed by industry remain stable in real terms – unclear if there are any shifts</li> <li>Cost of compliance staff varies between £80,125-£100,000 depending on type of fund</li> <li>Competitive service providers e.g. prime brokers, depositaries, external valuers and fund administration</li> <li>Our broad assumptions about the varying cost of these requirements remain generally robust</li> </ol>		

## BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:	In scope of OI2O?	Measure qualifies as
Costs: £0	Yes	OUT
Benefits: £0: benefits from reduction in regulation described qualitatively	Net: £0m	

# Summary: Analysis & Evidence

# Policy Option 3

Description: Implement AIFMD in line with the Government's preferred options for sub-threshold AIFMs

## FULL ECONOMIC ASSESSMENT

Price Base Year 2009	PV Base Year 2013	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low: -8,767	High: -4,247	Best Estimate: -6,507

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	245	887	4,247
High	377	1,858	8,766
Best Estimate	311	1,372	6,507

### Description and scale of key monetised costs by 'main affected groups'

The Government's preferred option applies a regime as close as AIFMD permits to status quo for all sub-threshold managers.. The fund management industry will face £226m-£353m in one-off costs and £863m-£1.8m in ongoing costs. Depositories may also £4m in one-off costs and £3m in ongoing costs. FSA will also incur one-off costs of £13.4m which are counted as non-business costs as they are directly accrued by the regulator. Costs within scope of One-In, One-Two are zero as the Government is not imposing new costs above the directive minimum.

### Other key non-monetised costs by 'main affected groups'

Status quo regime is effectively maintained for all sub-threshold managers so costs would be minimal for these managers. For above threshold managers, as option 1

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low			
High			
Best Estimate			
Best Estimate	Best Estimate	Best Estimate	Best Estimate

### Description and scale of key monetised benefits by 'main affected groups'

Potential benefits have not been quantified although evidence has been presented to support the general policy approach. The key benefits are set out in Option 1 although this approach represents a more proportionate approach to monitoring and addressing systemic risk

### Other key non-monetised benefits by 'main affected groups'

Investors - Option 3 gives greater investor protection for investors in sub-threshold authorised funds  
 Small Fund Managers - Option.3 generally maintains the status quo for sub-threshold fund managers.  
 Smaller fund managers are able to start-up and grow quickly which will allow niche sectors to develop  
 Fund management industry – flexible, pragmatic regulation will maintain confidence in UK regulatory regime  
 Small Private Equity fund managers – light depository requirements will ensure a competitive industry

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
<ol style="list-style-type: none"> <li>Population remains stable – no significant restructuring, consolidation or redomiciliation in/out of the UK</li> <li>Assets managed by industry remain stable in real terms – unclear if there are any shifts</li> <li>Cost of compliance staff varies between £80,125-£100,000 depending on type of fund</li> <li>Competitive service providers e.g. prime brokers, depositories, external valuers and fund administration</li> <li>Our broad assumptions about the varying cost of these requirements remain generally robust</li> </ol>		

## BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:	In scope of OI20?	Measure qualifies as
Costs: 0	No	N/A
Benefits: 0		
Net: 0		

# Summary: Analysis & Evidence

# Policy Option 4

**Description:** As option 3 but with removal of retail marketing restrictions

## FULL ECONOMIC ASSESSMENT

Price Base Year 2009	PV Base Year 2013	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low: -8,767	High: -4,247	Best Estimate: -6,507

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	245	887	4,247
High	377	1,858	8,766
Best Estimate	311	1,372	6,507

### Description and scale of key monetised costs by 'main affected groups'

Option 4 applies the same regime to sub-threshold funds as option 3 so direct costs will be as option 3. Removal of retail restrictions could lead to potential changes in Assets Under Management under option 4 – which would affect overall costs. These have not been quantified at this stage. Costs within scope of the Government's One-One Two Out policy are the same as for option 3.

### Other key non-monetised costs by 'main affected groups'

As option 3 – and in addition:

- Greater potential for retail investors to invest in funds which may well not meet their needs, for example funds with a long lock-in period or funds with considerable risk; and
- Loss of confidence in UK regulatory system as a result of investors making unsuitable investments.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low			
High			
Best Estimate			

### Description and scale of key monetised benefits by 'main affected groups'

Potential benefits have not been quantified although evidence has been presented to support the general policy approach.

### Other key non-monetised benefits by 'main affected groups'

As option 3- and in addition:

- Greater choice of investment for retail investors, who may now be marketed to by all funds, including hedge funds and private equity funds; and
- A wider market for the managers of funds who were previously unable to market to retail investors.

Key assumptions/sensitivities/risks

Discount rate (%) 3.5

1. Population remains stable – no significant restructuring, consolidation or redomiciliation in/out of the UK
2. Assets managed by industry remain stable in real terms – unclear if there are any shifts
3. Cost of compliance staff varies between £80,125-£100,000 depending on type of fund
4. Competitive service providers e.g. prime brokers, depositaries, external valuers and fund administration
5. Our broad assumptions about the varying cost of these requirements remain generally robust

## BUSINESS ASSESSMENT (Option 4)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	Benefits: 0	Net: 0		

## **PART A – POLICY CONTEXT FOR TRANSPOSITION OPTIONS**

### **BACKGROUND**

The Alternative Investment Fund Managers Directive (AIFMD) will establish an EU-wide harmonised framework for monitoring and supervising risks posed by Alternative Investment Fund Managers (AIFMs) and the funds they manage (AIFs); and for strengthening the internal market in alternative investment funds. The Directive contains provisions relating to the conduct of business, transparency and marketing, and provides for the cross-border managing and marketing of funds.

The Directive covers the managers of the major types of fund that are not already subject to EU regulation through the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, and as such covers managers of funds including hedge funds, private equity funds, venture capital funds and real estate funds.

AIFMD was adopted by the European Parliament and Council in June 2011 and must be transposed into national law by 22 July 2013. The Directive also provides for an extensive set of more detailed implementing measures which were adopted by the European Commission in December 2012. The European Supervisory and Markets Authority (ESMA) is providing further technical guidance, including on aspects of scope.

### **RATIONALE FOR INTERVENTION**

The Directive was introduced by the European Commission in the context of the systemic financial crisis of 2008 and the fraud perpetrated by Bernie Madoff in the United States. The rationale for intervention at a European level has been set out in the impact assessment of the European Commission:

- Regulatory fragmentation may **inhibit the effective regulation, supervision and macro-prudential oversight of AIFM by failing to take account of the cross-border dimension of their activities**. This may result in incomplete or inconsistent monitoring and control of the macro-prudential, micro-prudential and market efficiency risks; weaknesses in frameworks for ensuring investor protection; and insufficient public accountability of AIFM investing in and managing companies; and
- Regulatory fragmentation may also **impede market integration and the development of the single market** by creating barriers to the efficient cross-border distribution of AIFM products.

### **POLICY OBJECTIVE**

The stated objectives of the European Commission in introducing the Directive were:

- **Appropriate authorisation and registration requirements** for all AIFM operating in the EU: this would require all AIFM to respect and satisfy a common set of requirements (minimum capital, fit and proper, transparency, etc.) before operating across the EU;
- **Improved monitoring of macro-prudential risks** through the provision of relevant information to prudential authorities;
- **Enhanced management of micro-prudential risks** through the imposition of strict risk management controls on market, liquidity, counterparty and operational risk;
- **A common approach to protecting investors in AIFM-managed funds**, including improvements in investor disclosures to ensure that due diligence can be performed effectively;

- **Greater public accountability of AIFMs investing in and managing companies** to ensure that such activities are subject to an appropriate level of public scrutiny; and
- The **removal of barriers to the efficient cross-border distribution of AIF** to allow an internal market in AIFs in the European Economic Area to develop which is grounded in a robust and consistent regulatory supervisory framework.

AIFMD is mostly maximum harmonising with little Member State discretion over its implementation. However, there are decisions the Government may make, including the extent to which the AIFMs managing AIFs with assets under management below a defined threshold<sup>1</sup> may be permitted use of an exemption from the overwhelming majority of the Directive's requirements. AIFMs managing AIFs below the threshold are referred to in this impact assessment as sub-threshold AIFMs, with all AIFMs managing AIFs above the threshold deemed to be above-threshold AIFMs.

In implementing the Directive, the Government has the following objectives:

- Minimise gold plating in line with the Government's wider objectives to maintain and enhance UK competitiveness and minimise costs for investors;
- To maintain and expand investor choice and a competitive marketplace; and
- To maintain strong investor protection and the integrity of the regulatory regime.

## APPLICATION OF AIFMD

The Directive applies requirements to AIFMs and its impact is dependent upon the types of AIF being managed. UK AIFMs currently operate under one of four main regulatory regimes which are defined by the regulation of the funds managed:

- **Non-UCITS Retail Scheme (NURS) funds.** The NURS regime sets out requirements for AIFs wishing to market to retail investors and consequently offers a high level of investor protection. NURS is broadly similar to the pan-EU UCITS regime but permits a wider range of investments. The fund's operator and the fund itself are regulated by the FSA.
- **Qualified Investment Scheme (QIS) funds.** The QIS regime permits a greater range of investments than the NURS regime; consequently QIS funds may only be marketed to high net worth, sophisticated and professional investors. In practice, QIS funds are usually used as pooling vehicles by pension funds and other institutional investors, in order to lower the cost of management and achieve economies of scale in investment. Again, the fund's operator and the fund itself are regulated by the FSA.
- **Unregulated Collective Investment Schemes (UCIS) funds.** With a few exceptions (see below), nearly all other AIFs in the UK are unregulated. The fund's operator is authorised by the FSA but the AIF is not. The UCIS<sup>2</sup> regime offers considerable flexibility, and is normally marketed to high net worth, sophisticated and professional investors<sup>3</sup>. UCIS funds include hedge

<sup>1</sup> Article 3(2)-(4) provides that Member States may apply a less stringent regulatory regime with opt-in procedures such that smaller AIFMs may benefit from the EU AIF management and/or marketing passport under Chapter VI of the Directive. See also Section III of the Final Report on ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD, 16 November 2011

<sup>2</sup> UCIS are described as unregulated because they are not subject to the same restrictions as a regulated CIS such as regulations in relation to their investment powers and how they are run.

<sup>3</sup> The Financial Services Authority is currently reviewing whether UCIS funds are suitable for distribution to retail investors under *Restrictions on the retail distribution of unregulated collective investment schemes (2012) Financial Services Authority- [www.fsa.gov.uk/static/pubs/cp/cp12-19.pdf](http://www.fsa.gov.uk/static/pubs/cp/cp12-19.pdf)*



funds, private equity funds and venture capital funds. UCIS schemes also include complex structures such as fund-of-fund vehicles.

Enterprise Investment Scheme (EIS) funds, Real Estate funds and charity funds can operate in this framework although some real estate funds such as Property Authorised Investment Funds (PAIFs) and Funds of Alternative Investment Funds (FAIFs) are authorised by the FSA and charity funds are generally regulated by the Charity Commission.

- **Investment Companies** (internally managed). Investment companies are currently unregulated by the FSA, as they are excluded from the UK's definition of collective investment schemes. They include investment trusts, venture capital trusts and some limited liability partnerships. This impact assessment focuses on what we believe to be the largest group; investment trusts and venture capital trusts. Investment companies are subject to company law, and where appropriate listing requirements and the Prospectus Directive.

Investment companies have a board of directors but many will outsource the formal AIFMD management role to an external management entity, which will be currently subject to FSA authorisation under the UK implementation of the EU MiFID Directive. In practice, the UK will be putting in place a sub-threshold regime for external managers of investment companies that will be similar to the regime for UCIS AIFMs. For the purposes of calculating costs in this impact assessment only, external managers of investment companies are therefore considered together with the managers of UCIS funds. No inference should be drawn beyond this: for example, for marketing purposes, investment companies are considered separately.

Managers of investment companies which do not outsource the AIFM management role are considered as a separate category to UCIS AIFMs and for shorthand are described as internally managed investment companies.

## POPULATION OF FUND MANAGERS AND FUNDS IN SCOPE

The estimated population of UK AIFMs and the AIFs they manage, together with their assets under management (AUM) is as follows:

	Above-threshold AIFM			Sub-threshold AIFM			Total		
	AIFMs	AIFs	AUM (£m)	AIFMs	AIFs	AUM (£m)	AIFMs	AIFs	AUM (£m)
<b>NURS</b>	47	623	90,255	10	252	2,585	57	875	92,840
<b>QIS</b>	3	50	4,240	1	1	49	4	51	4,289
<b>UCIS</b>	342	631	394,405	366	670	43,825	708	1,301	438,230
<b>...Of which Private Equity</b>	129	310	87,527	94	290	12,000	223	600	99,527
<b>..Of which Investment Companies</b>	40	151	61,407	184	184	14,577	224	335	75,984
<b>Internally managed Investment Companies</b>	8	8	13,178	75	75	4,114	83	83	17,292

- For NURS and QIS populations and assets under management, the estimates are derived from data supplied by the Investment Management Association largely based upon returns to the IMA Annual Survey 2012.



- For investment companies, the estimates are derived from data supplied by the Association of Investment Companies (AIC). Following further consultation feedback, the AIC estimated that approximately 30 externally managed investment companies may restructure to become internally managed investment companies – we estimate each AIF as managing €100m each based upon conversations with AIC analysts.
- The AIC also advised that there were currently 105 Venture Capital Trust companies with £2.6bn in assets and all were likely to be sub-threshold. A simple average of this gives an average fund size of £24m. We understand from the AIC that a small proportion are likely to be internally managed so have assumed 10% of these are internally managed.
- For UCIS populations and Assets Under Management, the estimates are derived from FSA authorisations, supplemented with data from Morningstar, a commercial information service and have been considered by industry bodies and checked against CityUK estimates. The sub-threshold figure for private equity AIFMs was refined in order to take account of estimates provided by the representative industry body, the British Venture Capital Association.
- During consultation, it was highlighted that the number of sub-threshold UCIS AIFs was likely to be significantly higher than estimated, with many set up as real estate trusts. Data was then collected on real estate funds using market sources such as Bloomberg and this was appended to the UCIS category as found there was 142 active funds managed by 34 fund managers. This should be considered as an underestimate as they were 100 funds with insufficient data.
- Charity funds such as Common Investment Funds and Common Deposit Funds are grouped together with UCIS but the sub-threshold regime for this category will be considered in a second Treasury consultation paper. Our understanding is that there are no sub-threshold charity funds.

The populations are subject to uncertainty for reasons including:

- There isn't a single set of data for each of the populations. So for the UCIS population, where AIFMs are authorised, FSA will authorise a UCIS manager along with other investment managers. Thus, separating and then calculating the quantum of assets under management for the UCIS managers from that of investment managers is difficult;
- AIFMs will often manage more than one type of AIF. Working with FSA, we have attempted to remove duplicates through analysis of FSA permissions and Morningstar data; and
- There may well be movement within populations as a result of the implementation of AIFMD. So, for example, reducing regulatory requirements for some sub-threshold managers may encourage them to remain onshore. Some sub-threshold fund managers may seek to opt-in to the Directive requirements. This may be as a result of a commercial decision or in order to attract investors and also to market within Europe. We have so far received limited indications this will happen.
- The population figures are likely to change if there is consolidation in the asset management industry, particularly as fund managers seek to rationalise costs and improve efficiency in an increasingly competitive market. This is particularly likely to be the case as fund managers take advantage of the management passport in order to consolidate fund management of EU AIFs and offshore funds which are intended for EU investors<sup>4</sup>. There may also be consolidation and

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<sup>4</sup> Alternatives fillip for London (2013) Steve Johnston – FTfm Financial Times – Monday 18<sup>th</sup> February 2013

reconstruction of funds – one survey estimated a 10-30% reduction in the number of European funds<sup>5</sup>.

- The introduction of AIFMD will also squeeze business margins making it likely to trigger further consolidation within the sector in order to save costs. AIFMD will increase the overheads and costs upon AIFMs and some may find it increasingly difficult to pass these costs onto the fund or its investors. Whilst many AIFMs have both management and performance elements to their compensation, sluggish performance over the past few years has meant that some are relying on management fees alone. This may mean that unless the smallest fund managers are very high performing, they may not survive unless they grow in size.
- Some AIFMs may seek to exit the EU so that some of the Directive costs don't apply, for example the burdensome Depositary requirements; the potential for this is confirmed by AIMA based upon a survey of its members. It is likely that other AIFMs will want to move into the EU, however, in order to be able to make use of the marketing and management passports.
- It is likely that Unauthorised Unit Trusts managed have not been caught; however they are managed by AIFMs already captured in this impact assessment through their management of other AIFs (though their Assets Under Management have not been captured).

## **PART B – APPROACH TAKEN IN THIS IMPACT ASSESSMENT**

The Directive is mostly maximum harmonising with only limited Member State discretion over its implementation. However, there are a number of Member State derogations, and three decisions in particular will have a significant impact. The Government must decide on:

- **Treatment of sub-threshold AIFMs.** Sub-threshold AIFMs may be exempt from the vast majority of the Directive's requirements. However, Member States may decide to require some or the entire Directive's other requirements to be applied to sub-threshold AIFMs. The operators of NURS, QIS and UCIS are already authorised, though the Directive's requirements go beyond the existing regime, and the UK will need to decide whether to largely maintain the status quo, scale back existing requirements where permitted or impose the full requirements of the Directive on sub-threshold AIFMs.
- **Marketing of AIFs to retail investors.** By default, the Directive does not permit the marketing of AIFs to retail investors, however the UK may maintain or modify its existing retail regime, in which NURS and investment companies may be marketed to all investors, and QIS and UCIS to sophisticated and high net worth retail investors.
- **Private Placement Regime.** Managers based overseas are required to be subject to conditions that have the same effect as the Directive. However, until at least 2018, the UK has the option to permit overseas managers to market to professional investors in the UK through "private placement". These managers will only be subject to minimal Directive requirements.

## **IMPLEMENTATION OPTIONS**

This impact assessment first sets out the overall qualitative benefits and costs of introducing the Directive, before assessing the impact of the decisions the Government must take. In practice, given the breadth of AIFMD, there are numerous potential permutations of options relating to the three issues above. To provide meaningful support for the decisions the Government is realistically likely to take, this impact assessment considers four options:

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<sup>5</sup> A survey by Platform and Cerulli Associates of 70 fund managers, platforms and distributors found 62% anticipate 10%-30% fall in the number of funds in Europe in 2013 in Big Squeeze on fund numbers (2013) Steve Johnston, FT Financial Management Feb 18 2013

- **Options 1 - 3** vary the cost of implementation by modifying the sub-threshold regime – representing maximum gold-plating, no gold-plating, and the Government’s preferred, intermediate, option – a sub-threshold regime that the Government considers to represent an appropriate balance of investor protection, costs and flexibility.
- **Option 4** builds upon the Government’s preferred option – option 3 – by qualitatively considering the impact of further deregulation through the removal of retail marketing restrictions.

All options are assessed against a notional **Option 0**, not to implement the Directive. This option has been discounted; it would be counter to the UK’s treaty obligations, infraction proceedings would be taken, UK AIFMs would lose the right to passport AIFs around the EU, and the UK would lose credibility when seeking to influence future negotiations.

There are two further regulatory decisions that the Government could take in relation to the three issues above but that have been discounted at an early stage and therefore not considered further in this impact assessment. Both involve significant gold plating:

- **Restricting further the marketing AIFs to retail investors.** At present, NURS AIFs may be marketed to retail investors, and QIS and UCIS AIFs may be marketed to high net worth and sophisticated investors who aren’t classified as “professional” under the EU MiFID definition of the term. The UK could decide to restrict further the marketing of these regimes – either by closing NURS to retail investors or by restricting the marketing of QIS and UCIS to professional investors only.

The Government has decided not to place further restrictions on marketing; a position supported by nearly all respondents to an earlier Treasury discussion paper. NURS has been designed for retail investors so the Government considers it suitable. More broadly, the Government considers the current investor protections in QIS and UCIS to render them suitable to sophisticated and high net worth individuals.

- **“Levelling up” the UK’s private placement regime.** AIFMD permits member states to maintain a national private placement regime for at least the first five years from when the Directive comes into force. Third country (i.e. non-EU) managers of third country AIFs that wish to market their funds to UK professional investors need comply with only minimal Directive requirements. However, the Government may opt to apply some or all additional Directive requirements for these managers.

If the UK were to do this, it would represent a significant change from the current UK approach and an increase in investor protection. However, it would also increase costs and reduce investor choice. The Government therefore intends to maintain the current approach, in which professional investors are judged to be protected by the regulation of the third country, and to be in a position to undertake their own due diligence. This position was supported by nearly all respondents to the earlier Treasury discussion paper and respondents to the consultation also confirmed this.

## APPROACH TAKEN TO DEVELOP IMPACT ASSESSMENT

Both the Treasury and the Financial Services Authority published discussion papers in early 2012 asking for qualitative industry feedback on their proposed approach. In addition, the FSA conducted a quantitative survey in spring 2012 on the costs of implementing the Directive, with 36 AIFMs responding. The impact assessment has used the responses to these as a starting point and validated assumptions against other sources including discussions with trade bodies, companies and reports including:

- Charles River Associates (2009) 'Impact of the proposed AIFMD Directive across Europe'.<sup>6</sup> The CRA report was commissioned by the FSA;
- Deloitte (2012) 'Responding to the new reality: Alternative Investment Fund Managers Directive Survey'<sup>7</sup>;
- Ernst & Young (2012) 'AIFMD: get ready for European depositary reform'<sup>8</sup>; and
- The European Commission's impact assessment from 2009.<sup>9</sup>
- European Commission Impact Assessment on Implementing Regulations for AIFMD (2012)<sup>10</sup>

Further feedback was sought during the consultation, with trade bodies and advisors asked directly to validate assumptions, and all respondents to the consultation paper asked to provide feedback where possible in order to set out the practical considerations in the implantation of the directive.

The costs and benefits were also reviewed against the available literature, particularly where empirical studies were undertaken in order to provide evidence of the likely costs and benefits, if not quantitative estimates. Recent briefings to industry were also taken account of where possible as this reflected the industry's own understanding of the likely directive requirements and their impacts.

In addition, we worked through four trade bodies to ask sub-threshold AIFMs to complete a high-level survey of likely costs. The response rate was low with 4 responding, of whom three were sub-threshold NURS AIFMs we contacted directly. All reported a high level of uncertainty over the costs. We also asked small and medium sized hedge funds but cost data, with a similarly low response rate. In addition, we spoke with a number of compliance officers and previous respondents to our consultation and discussion paper<sup>11</sup> in order to understand their perceptions. This has been fed into our impact assessment where possible.

## LIMITATIONS TO APPROACH

Despite the focus on the Directive from a large number of AIFMs and other bodies, there is considerable uncertainty over the costs of implementing the Directive. This was particularly true when the cost survey was conducted. The main reasons for this are:

- AIFMD is a new, complex Directive with a broad reach, and AIFMs are only beginning to consider the costs and benefits. In many cases, AIFMs themselves do not yet know how much it will cost them to implement – or the degree of restructuring they are likely to need to undertake;
- Some costs will depend upon a new market equilibrium. This is particularly the case for depositaries, whose regime is one of the mostly costly elements of the Directive; and
- Some detailed implementing measures at a European level were only just available at the time of this impact assessment's preparation, which has meant that firms had not yet been able to fully

<sup>6</sup> The CRA report can be accessed here: [http://www.fsa.gov.uk/pubs/other/Impact\\_of\\_AIFM\\_Directive.pdf](http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf)

<sup>7</sup> The Deloitte report can be accessed here: <http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-aifmd-survey-responding-new-reality.pdf>

<sup>8</sup> The Ernst & Young report can be accessed here: [http://www.ey.com/Publication/vwLUAssets/AIFMD\\_-\\_prepare\\_for\\_European\\_depositary\\_reform/\\$FILE/AIFMD\\_20March2012.pdf](http://www.ey.com/Publication/vwLUAssets/AIFMD_-_prepare_for_European_depositary_reform/$FILE/AIFMD_20March2012.pdf)

<sup>9</sup> The European Commission's impact assessment from 2009 can be accessed here: [http://ec.europa.eu/internal\\_market/investment/docs/alternative\\_investments/fund\\_managers\\_impact\\_assessment.pdf](http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf)

<sup>10</sup> [http://ec.europa.eu/internal\\_market/investment/alternative\\_investments/index\\_en.htm](http://ec.europa.eu/internal_market/investment/alternative_investments/index_en.htm)

<sup>11</sup> Policy Options for Implementing the Alternative Investment Fund Managers Directive (2012) HM Treasury

assess their impact. Some further details are still awaited. Dependence on these is highlighted in the relevant sections.

Further limitations at this stage are:

- **The overall increase or reduction in assets managed or domiciled within the UK cannot be determined at this stage.** AIFMs make a significant economic contribution to the UK economy through taxation and employment - and a change in the assets under management would affect this. The impact of AIFMD is too uncertain at this stage to quantify a potential shift into or out of the UK so the effects of any potential shift are described qualitatively.
- **Restructuring costs that are dependent upon more detailed implementing measures at a European level about which there is not yet certainty.** In particular, it is possible that some restructuring would be necessary as a result of more detailed provisions on delegation. Final measures have been published but national regulators are still to confirm how these will be implemented, moreover industry is still considering their impact. The impact assessment therefore notes qualitatively the potential impact.
- **Costs are borne by AIFMs.** We assess the costs to the extent that they are incurred by AIFMs, but have not modelled or assessed how these may be passed through to other parties, including investors. In practice, some may be borne by related parties or service providers, for example depositaries, or passed onto investors through higher fees and expenses. To determine the equilibrium of costs would require a set of assumptions about the profitability of a heterogeneous set of AIFMs and the competitive pressure brought to bear. Investors including institutional investors such as pension funds that seek to pass costs on to end clients. Industry has indicated it will seek to pass on some or all costs to investors but at this stage, there is insufficient evidence to make the assumptions necessary to attempt to apportion the costs between the participants.

Costs to non-UK AIFMs, from within the EU and from third countries are not considered as they are out of scope for this impact assessment.

## ASSUMPTIONS

The costings in this impact assessment are particularly sensitive to the following factors and assumptions:

- **Variation of costs across the four regulatory regimes.** The cost of AIFMD will differ by sector on account of the different rules currently in place, and variations in the size, risk and complexity of the assets being managed. This impact assessment makes some high level assumptions around variation which were tested during consultation. The assumptions are based upon a high-level gap analysis to determine the extent to which AIFMD requirements are new, any published evidence on costs across the regulatory regimes, and reasonable deductions about applicability of the Directive. Some AIFMs manage more than one type of AIF and we have sought to avoid double-counting;
- **Variation of costs for sub-threshold AIFMs.** Given that the Government must decide on its preferred regime for sub-threshold AIFMs, the costs for this group needs to be determined. There were very few responses to the FSA survey from sub-threshold firms as this group was not specifically targeted. Where AIFM-level costings are often expressed in terms of a range with high and low estimates for the above threshold AIFMs, unless otherwise stated, the lower cost estimate for the activity has been used when calculating sub-threshold AIFMs. However, where this seems to be implausible, based upon discussions with FSA and industry, we have estimated a lower figure, usually the lower bound or half the lower bound.

- **Transition.** Consultation feedback is that some AIFMs will apply for authorisation in time for July 2013 while others will make full use of transitional arrangements under AIFMD which give them until July 2014 to apply for authorisation. We have assumed that one-off costs will apply in year 0 and ongoing costs for subsequent years.
- **Labour costs.** Our interim impact assessment concluded that the average cost for compliance and other staff across sectors was £65,000 p.a. including overheads. This assumption was based upon industry surveys at the time. The surveys are the Hudson Banking and Financial Surveys 2012 Salary Guide for London<sup>12</sup> and the Alexander Lloyd Compliance Staff Survey 2012<sup>13</sup>.

Our review with industry bodies and firms themselves indicated that our earlier estimate of compliance costs for UCIS AIFMs was too low. This is because an operationally independent compliance officer would need to have both experience and seniority which would require salaries starting from £100,000 per annum. We have therefore applied this cost for UCIS AIFMs. The figure for NURS, QIS and internally managed investment company compliance staff was felt to be a 25% underestimate and was raised to £81,250. Assuming a 225 day working year, this works out at £444 & £361 per day for UICS & NURS, QIS and internally managed investment company compliance staff respectively.

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<sup>12</sup> Hudson 2012 Banking and Finance Staff Salary Survey <http://uk.hudson.com/Portals/UK/documents/SalarySurveys/banking-finance-salary-survey-2012.pdf>

<sup>13</sup> Alexander Lloyd Compliance Staff Salary Survey 2012  
<http://www.alexanderlloyd.co.uk/content/Alexander%20Lloyd%20Compliance%20Salary%20Survey%202012.pdf>

## **PART C – COSTS AND BENEFITS OF IMPLEMENTATION**

The analysis of costs and benefits is divided into two sections:

- Section A is a broad description of the main requirements of AIFMD, together with their overall qualitative benefits and costs; and
- Section B considers through options 1-3 how the Government may apply the requirements of AIFMD to sub-threshold AIFMs, and considers the more specific qualitative and quantitative costs and benefits that derive from these decisions, Option 4 then considers qualitatively the impact of further deregulation through the removal of some or all retail marketing restrictions.

### **SECTION A - MAIN REQUIREMENTS, BENEFITS AND COSTS OF THE DIRECTIVE**

The Directive makes the following requirements:

#### **A Authorisation & registration**

The Directive requires AIFMs to be authorised by a Competent Authority as the basis for regulatory oversight. To become authorised, the AIFM must meet the standards set out in the Directive, supply information on itself and the AIFs it manages, and hold a minimum amount of capital.

The principal benefit is investor protection; the FSA will have regulatory oversight of the AIFMs, be able to exercise its supervision responsibilities and where necessary to apply sanctions. In the UK, authorisation is already the cornerstone of financial regulation.

The Directive allows AIFMs managing sub-threshold AIFMs to be subject to a much more limited registration regime, which limits FSA regulatory oversight and imposes few requirements. Sub-threshold AIFMs have the right to opt up to full authorisation in order to benefit from a pan-EU management and marketing passport.

#### **B General operating and organisational conditions**

The Directive sets out a series of conditions governing how AIFMs should be run. The primary benefit of these conditions is again investor protection. In practice, many of the principles behind these requirements are in place in regulation or in current practice. AIFMD strengthens the requirements further and applies them in a uniform manner. The conditions are:

- AIFMs must have a strong **risk management system** in place. This includes ensuring a risk management function that is functionally and hierarchically separated from operational units in order to ensure genuine independent challenge. This should provide investors with confidence that risk is in line with fund and investor objectives;
- AIFMs must have effective organisation and administrative arrangements in place to manage and, where appropriate, prevent **conflicts of interest**. There are particular requirements on AIFMs, typically hedge funds, in selecting prime brokers to ensure clarity over reuse of AIFs' assets and to ensure appropriate due diligence is undertaken;
- AIFMs are required to ensure that where they invest in loans that have been repackaged into **tradeable securities**, the originator has met particular conditions, including the original lender retaining a net economic interest of not less than 5%; and
- AIFMs are subject to **capital requirements** that reduce the risk of an AIFM failing; and help to ensure that if it does fail, transition of the AIF to a new manager or an orderly run-down may be



carried out smoothly. Most asset management companies already hold substantial capital under the requirements of the Capital Requirement Directive (CRD), but the requirements is new for private equity and venture capital funds, which are not currently subject to CRD.

### **C Delegation provisions**

AIFMs may delegate their functions to third parties but must demonstrate there are objective reasons for doing so and that the delegate is capable of taking on such a task. They must also notify their Competent Authority. AIFMD includes the requirement that the AIFM mustn't delegate to the extent that it becomes a "letterbox entity" which is incapable of providing effective oversight and control, among other requirements;

The principal benefit of the delegation provisions is investor protection. The requirements ensure that where AIFMs appoint third parties to help manage the funds, the same high conduct requirements are maintained and that the AIFM retains overall control rather than becoming a "letterbox entity".

### **D Liquidity management requirements**

AIFMs are required to employ an appropriate liquidity management system in order to ensure AIFs can meet their obligations to investors seeking to redeem their investments in accordance with AIF rules. There are a range of tools<sup>14</sup> and arrangements which are open to some AIFMs to manage liquidity risks. This should reduce the risk that a fund defaults in times of market stress due to liquidity constraints. Stress testing is required to support this.

### **E Leverage requirements**

As part of the risk management system, AIFMs are required to set a **maximum level of leverage** which they employ for each AIF, depending upon factors including the type and investment strategy of the AIF, interlinkages with other financial services institutions, the need to limit exposure to counterparties and the extent to which the leverage is collateralised;

### **F Remuneration requirements**

AIFMs must have **remuneration policies and practices** in place for significant staff that are consistent with and promote sound risk management; apply proportionately a set of principles which govern implementation and oversight of remuneration policy; and make appropriate use of variable remuneration;

The remuneration provisions help to align incentives of the AIFM and the investors; and reduce the risk of individuals seeking short-term gains at the expense of long-term performance;

### **G Valuation requirements**

AIFMs are required to ensure that AIFs are valued to a consistent standard and that the **valuation is carried out independently** – either through an external valuer or within the same AIFM so long as functional separation is assured from the portfolio management group.

### **H Transparency requirements**

AIFMs are required to ensure that AIFs are valued to a consistent standard and the Directive places obligations on AIFMs both to investors. AIFMs must make available an annual report produced to set standards and make available an extensive set of further information around the AIFM and AIF and how

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<sup>14</sup> Hedging Liquidity Risk: Potential Solutions for Hedge Funds (2008) R Bhaduri, CFA Institute

they are run. The transparency requirements increase the level of information available for smaller professional investors, reducing information asymmetries and helping to increase investor protection.

## I Reporting Requirements

AIFMs must also make available information to allow systemic risk to be assessed by the Financial Services Authority. In exceptional circumstances, the Financial Services Authority may require additional reporting or limit the leverage the AIF may deploy.

## J Depositary requirements

The Directive requires AIFMs to appoint a depositary to hold in custody set categories of financial instruments and to verify ownership. Depositaries must also ensure AIF cash flows are properly monitored and provide oversight to ensure AIFs are run legally and in accordance with the law. Depositaries have significant liability to investors – for assets held in custody, depositaries would normally have a restitution obligation in the event of loss. Depositaries may delegate part of their role – but their ultimate liability normally remains.

Again, the principal benefit of the depositary requirements is investor protection. In the UK many AIFMs are already required to have a depositary for certain categories of AIF – or at least a custodian for assets - but this regime is extended to all AIFs and the liability regime for depositaries has been strengthened. In practice, there are stronger requirements on depositaries to prevent investor loss; and greater requirements to make restitution in the event of loss. Investors will therefore have greater certainty that their assets are being managed and held in compliance with schemes rules and that there will be restitution in the event of detriment caused by fraud or insolvency.

## K Private Equity provisions

The Directive places specific obligations on Private Equity AIFMs to make disclosures to their Competent Authority in the event of acquiring significant holdings in non-listed companies, and to the company and the shareholders in the event of acquiring control of the company. AIFMs are required to ask that this information be made available to employees and to set out their intentions for the company. The Directive also has provisions to prevent asset stripping through preventing distributions for the first 24 month following a Private Equity AIF's purchase of a company. The principal benefit is therefore employee protection.

## G Passporting provisions

The Directive introduces a 'single market framework' for AIFs. It provides for two types of passport:

- A **management passport** will allow AIFMs to manage AIFs in other member states, subject to a notification procedure. This has the potential to reduce costs associated with running management companies by allowing funds to consolidate management activity. In practice, cross-border management of AIFs already takes place widely; the provisions extend the practice to all member states and standardise the notification procedure. Currently funds may in some cases be required to appoint a management company in the same jurisdiction as the funds but the management company will then delegate to managers in other jurisdictions. Ensuring that AIFs may be managed across EU borders could lead to consolidation of management activity and a reduction in cost for investors.
- A **marketing passport** will permit AIFs managed by UK AIFMs to be marketed to professional investors in other member states, subject to a notification procedure. In practice, this already happens widely but is either dependent upon the private placement regime of the individual Member State or the use of reverse solicitation. AIFMD requires all Member States to allow passporting and has the potential to reduce costs by introducing a standardised process for doing

so. Where a Member State already has a liberal private placement regime with low regulatory requirements, this is unlikely to lead to significant savings (and may lead to increased regulatory costs for notification etc) but in other Member States it could do so.

## Overarching costs of the Directive

The Directive creates direct and indirect costs, which are described below.

### **Direct Compliance costs**

Many of the AIFM requirements are based on current regulatory requirements or established market practice. However, as noted above, some requirements will impose significant extra cost, including the additional depositary and transparency requirements. Most AIFM will have to take legal advice and review and invest in their governance and controls framework, hire staff and invest in training, review and update policies and procedures and install and invest in new infrastructure and systems to become compliant. All AIFMs will need to be authorised by the FSA which will involve providing the regulator with the information required and complying with reporting requirements.

Options 1- 3 seek to quantify these higher costs, and option 4 builds qualitatively upon option 3. With the exception of capital requirements, these costs have been taken account of in the bottom-up assessment of the costs , FSA has undertaken analysis<sup>15</sup> of above-threshold AIFMs, based upon regulatory data firms are required to report on an ongoing basis.

AIFMD has two capital requirements:

- A capital requirement for own funds that reduces the risk of an AIFM failing; and that if it does fail, transition of the AIF to a new manager or an orderly run-down may be carried out smoothly; and
- Additional own funds to cover potential liability risks arising from professional negligence. Potentially some of this requirement may be covered instead through an increased professional indemnity insurance.

Calculation of capital is subject to uncertainty due to uncertainty over how industry will restructure. For example, some private equity AIFMs may delegate some activities to reduce capital requirements<sup>16</sup>.

NURS, QIS and many UCIS (excluding venture capital and private equity) AIFMs are already subject to capital requirements under the UK's existing regime; the capital requirements are quite high as they were originally designed for banks. The FSA's analysis is that the AIFMs already have sufficient capital to meet the first of the two capital requirements, but there is in total a £104.1m shortfall of capital to meet the additional professional negligence liability requirement. The capital shortfall has been added to each option but does not include shortfalls for sub-threshold AIFMs which cannot be estimated until AIFMs start to authorise with the FSA.

A survey by Deloitte concluded that a third of UK AIFMs may need to increase their professional indemnity insurance cover as a result of these new requirements<sup>17</sup>. Smaller boutique UCIS AIFMs with higher Assets Under Management would be particularly affected<sup>18</sup>.

Venture capital AIFMs are currently subject to a lower £5,000 capital requirement. Many above-threshold firms already hold own funds that are significantly greater than AIFMD levels. However, for other firms, the FSA has calculated a total capital shortfall of approximately £31.6m under the AIFMD. Like for other firm categories, the professional negligence requirement will be new and, on an aggregate basis, firms would have to increase own funds by approximately £7m to meet it.

<sup>15</sup> FSA AIFMD consultation paper, November 2012

<sup>16</sup> AIFMD Impact on Private Equity – PWC – Navigating the regulatory maze –PWC Luxembourg – November 2010

<sup>17</sup> Responding to the New Reality – AIFMD Survey (2012) Deloitte

<sup>18</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

For internally managed non-CIS AIFs, the FSA analysed the latest balance sheets of eight above-threshold investment trusts based on their reported assets under management. As these investment trusts are large active investors, they tend to have large amounts of cash and cash equivalents on the balance sheet, as well as substantial equity (an approximation for own funds). The AIFMD capital requirements for these firms, including additional own funds for the professional negligence requirements are less than the cash on their balance sheet. Based on this analysis, the FSA does not expect a capital shortfall for this type of AIF.

Feedback from BVCA, the industry body for private equity and venture capital firms, indicates that any capital shortfall identified for private equity / venture capital funds is most likely to be met from “own funds” as management fees are agreed upfront, while holding capital in liquid assets prevents it from generating revenue through investment. This was confirmed through informal roundtables where the requirement to hold additional capital was felt to be a factor in driving down performance<sup>19</sup>

It is not yet clear whether some of the additional negligence requirements will be met through increased professional indemnity insurance. A survey by Deloitte concluded that a third of UK AIFMs may need to increase their professional indemnity insurance cover as a result of these new requirements<sup>20</sup>.

The costs are assumed to last for five years. By this point the Directive and its provisions will be subject to review by the European Commission and depending upon the review may be subject to substantive changes invalidating the justification to hold the assumptions set out in this impact assessment.

### **Indirect costs through impact on business models and strategies**

It is likely that a number of AIFMs will restructure in order to comply with the Directive in the most efficient manner. The extent of restructuring is unclear as this depends upon commercial decisions that will now need to be made based upon Commission implementing measures that had only just been released at the time this impact assessment was finalised. It is therefore not possible to quantify the impact at this stage.

However, a number of reports have set out qualitatively the potential impact. These include the CRA report commissioned by the FSA<sup>21</sup> and a Deloitte survey. For example, 89% of respondents to the Deloitte survey did not expect the Directive to have an impact the investment strategies of their funds. However, the forthcoming Level 2 regulations on delegation may change the nature of relationship between AIFMs and service providers, particularly if managers are not longer allowed to outsource as many functions as they did in the past.

Other changes are also possible. For example, if depositary costs are too high, informal feedback from industry is that some AIFMs may seek to reduce costs by changing their execution strategy – for example from equities to synthetic exposure.

There are also likely to be broader costs as a consequence of the directive. The transposition will permit non-bank depositories to be established in order to serve closed-ended AIFs. Similarly, the level 2 regulations have clarified the arrangements with regards to custody. Ernst & Young’s analysis<sup>22</sup> suggest prime brokers are generally likely to be appointed by the depository as a custodian and are therefore likely to work with a limited number of trusted prime brokers.

<sup>19</sup> Informal paper collated by SNR Denton (2012) Rosali Pretorius, SNR Denton

<sup>20</sup> Responding to the New Reality – AIFMD Survey (2012) Deloitte

<sup>21</sup> See, in particular, European Commission’s impact assessment

([http://ec.europa.eu/internal\\_market/investment/docs/alternative\\_investments/fund\\_managers\\_impact\\_assessment.pdf](http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf)) and the CRA report (link in footnote number 2).

<sup>22</sup> Alternative Investment funds: Challenging Months ahead – European Commission releases AIFM level 2 (2012) Ernst & Young

There is also likely to be more scrutiny of funds which employ significant leverage as part of their investment strategy. Evidence submitted to ESMA by industry reflected this would particularly be the case for the gross method which takes into account all assets and all leverage embedded in derivative positions. The Commission's view is that this is likely to help investors with a preference discriminate between more passive funds rather than those which generate alpha.

### **Competitiveness costs**

As noted above, there are potential competitiveness benefits as a result of introduction of passporting and the establishment of a brand. However, as with any regulation, there is a risk of going too far, with the risk of an increase in compliance or depositary costs causing a number of AIFMs to withdraw from the EU market. Respondents to the Deloitte firm survey indicated that compliance costs are particularly likely to affect medium-sized AIFMs above the AIFMD threshold, as compliance costs are likely to constitute a larger proportion of total costs than for larger firms. This means that larger firms may have a cost advantage compared to the smaller firms. Some respondents to the FSA firm survey were concerned that depositary costs could force AIFMs to re-domicile to non-EU jurisdictions.

Incentives to relocate will be largely affected by the regimes to be introduced in the other non-EU countries. 66% of AIFMs that responded to the Deloitte firm survey think that AIFMD will reduce the competitiveness of the EU AIF industry.

Regulating previously non-regulated firms and requirements for non-EEA AIFMs may also increase barriers to entry.

On the other hand, the UK markets for AIFs may become more competitive if managers from elsewhere in the EEA use the new marketing passport to market funds in the UK. However, respondents to the Deloitte survey did not think that the benefits of the passport will be sufficient to compensate for the increase in compliance costs.

### **Economic Costs**

As noted above, in the longer term there are potential economic benefits from introducing AIFMD. However, the imposition of additional regulation upon AIFMs will increase business costs and reduce returns – there is a risk that fund managers may consolidate resulting in less competition. Some fund managers manage funds which specialise in the investment of European SMEs which are conducive to economic growth. Industry bodies stress that curtailing investment in this sector would lead to less investment in UK firms, reducing competitiveness.<sup>23</sup>

The broader investment management industry is a key part of the UK's financial sector, managing £4.9 trillion of funds and earning an estimated £12 billion a year for the UK. It is a major source of funding for the economy, accounting for over a third of all investment in UK equities. The industry is a significant provider of high value-added jobs and skills, with clusters of expertise in London, Scotland, Belfast and across many UK regions.

Our assessment is that it is too early to forecast the potential impact on UK GDP as a result in changes in fund management populations. There are also likely to be tax revenue and employment benefits as a consequence of reduced fund management activity in the UK. Research by OpenEurope suggested UCIS fund managers (private equity and hedge funds) contribute £5.3bn in tax revenue each year and employs 18,000 people directly. Although this research has been developed to make a pro-industry case so should be viewed in in this context, it illustrates the contribution of the sector

### **Costs to FSA**

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<sup>23</sup> Impact of the proposed AIFM Directive on Venture Capital (2012) European Venture Capital Association

The FSA estimates the one-off costs to FSA of implementing the AIFMD are currently estimated as £13.4m<sup>24</sup>. These cover staff costs and costs of anticipated systems developments following the high-level gap analysis on the back of the initial interpretation of the Directive:

- Scope changes given the extent of AIFMD regulation and categories of firms affected
- Interpretation of Directive, production of consultation papers, Policy Statement and Revised Handbook;
- Definition of operational requirements to administer Directive – authorisation, supervision and reporting;
- Revision to operational processes and procedures;
- Revision/Development of IT systems;
- Communication to all relevant stakeholders – internal and external; and
- Project and line management.

Additional supervisory staff may be needed on an ongoing basis due to the increase in the number of regulated firms. However, most potential AIFMs are already authorised by the FSA, so it does not expect a significant number of new managers, either start-ups or new entities consolidating previous businesses. In particular, investment managers of NURS, QIS and UCIS and the external managers of investment companies are already authorised and supervised by the FSA.

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<sup>24</sup> Implementation of the Alternative Investment Fund Managers Directive CP13/09 (2013) Financial Services Authority  
<http://www.fsa.gov.uk/static/pubs/cp/cp13-09.pdf>



## **Overarching benefits of the Directive**

In summary, the principal benefits of the Directive are:

### **Benefits to the Broader Economy**

#### ***Pre-emption of a Systemic Financial Crisis***

A principal benefit of the Directive is to increase the ability of regulators to monitor and manage systemic risk, as part of a wider regulatory framework governing Europe's financial system. The transparency requirements allow regulators to receive and exchange information on leverage and give them the power to intervene to prevent a future financial crisis by placing limits on the leverage.

This measure can be an important benefit for AIFMs as it helps supervisors to focus on risks where they are actually crystallising. During the financial crisis, some key figures<sup>25</sup> identified the concentration risks emerging in relation to CDS exposure to banks to counterparties with hedge funds exiting from the market. The FSA now currently monitors exposure to CDS as part of its hedge fund survey which is published bi-annually<sup>26</sup>. Some AIFs are considered a major source of counterparty risk for the providers of leverage, mainly prime brokers. The directive enables the FSA, in conjunction with other European authorities to intervene and impose limits on leverage when necessary and to bring more stability and integrity to the financial system.

There is little evidence that alternative funds played a central role in the financial crisis but they may have contributed to it by transmitting and magnifying risks.

The use of leverage increases the volatility of an investment and is used in the hope of amplifying investment returns. However, it also increases the risk of major losses for AIFs and of counterparty default for the providers of leverage. During the financial crisis, rising asset prices increased the value of collateral held which in turn allowed an AIF to obtain more leverage. However, this worsens the risk to investors when the credit cycle adjusts, banks call in their exposures and funds are vulnerable to margin calls resulting in forced asset sales. There is a significant body of research<sup>27</sup> which shows that when a highly leveraged institution is forced to unwind a significant fraction of its portfolio in a collection of illiquid markets, then it disrupts those markets and raise the probability of defaults (fund failures).

Leveraged investment funds, particularly hedge funds, were perceived to have worsened the deflationary spiral in asset prices as these funds relied on banks and prime brokers to fund their exposures. Drops in asset prices prompted prime brokers to cut financing, raise margins or ask for more collateral forcing hedge funds into fire sales reducing asset prices further<sup>28</sup>.

A study into the experiences of several open economies concluded that highly leveraged hedge funds could impact on short-term macroeconomic stability under stressed economic conditions<sup>29</sup>. There is one often quoted example of alternative funds creating excess systemic risk; the collapse of the United States hedge fund, Long Term Capital Management (LTCM), which required a bailout of \$3.6bn overseen by the Federal Reserve Bank of New York. Its collapse resulted in interest rates on corporate

<sup>25</sup> Comment of Christian Noyer (2009) [Governor of the Banque de France](#)

<sup>26</sup> Assessing the possible sources of systemic risk from hedge funds – August 2012 (2012) [Financial Services Authority](#)

<sup>27</sup> Forced Portfolio Liquidation (2007) C Ewerhart and N Valla, [Banque de France](#) sets out this risk with a policy recommendation to ensure the fund can generate more liquidity than its contingent liabilities.

<sup>28</sup> Rethinking Asset Management: From Financial Stability to Investor Protection and Economic Growth (2012) M de Manuel, Centre for European Policy Studies

<sup>29</sup> Report of the Market Dynamics Study Group of the Financial Stability Forum – (2000) Working Group on Highly Leveraged Institutions – Financial Stability Board

debt rising relative to rates on Government debt<sup>30</sup>. LTCM was highly leveraged and were a similar risk to occur under the Directive, regulators would be well placed to identify it and take preventative action.

The UK already has a mechanism in place for identifying hedge fund systemic risk, the FSA surveys of hedge funds and counterparties of hedge funds. The surveys have been run annually since 2005 (2009 for hedge funds) and has so far not identified any particular systemic risks. The Directive strengthens this arrangement by requiring mandatory reporting, covering a broader range of funds and allowing for pan-European monitoring so broader trends can be identified and addressed.

There is evidence that the harmonised collection of leverage data<sup>31</sup> would help to prevent systemic risk from crystallising. An academic study<sup>32</sup> found that indicators predicting a systemic crisis rose from 1.1% to 60% once embedded leveraged positions were taken into account.

## **Benefits to the Fund Management Industry**

### ***Single market benefits***

In a UK context, the management and marketing passports have the potential to:

- represent an export opportunity, improving the ability of UK AIFMs to enter other EEA markets, potentially enhancing the international competitiveness of the UK; and
- lead to increase competition and lower costs for UK investors.

These benefits will be particularly important for real estate funds as the current market is very fragmented along national borders and passporting could give rise to significant economies of scale.

We do not believe that it is possible to quantify accurately at this stage the single market benefits of the marketing and management passports. These will:

- depend substantially on the uptake of the new opportunity by a heterogeneous group of AIFMs which it is not possible at this stage to predict; and
- require data in order to calculate, such as the number of UK AIFs currently being marketed in other Member States which is not readily available and would require a disproportionate effort to gather or calculate.

There are still no firm data on the extent to which industry will seek to use the management and marketing passports, however anecdotally there has been vocal industry demand to be authorised on day one of AIFMD in order to benefit from the marketing passport. This is in part because other Member States have chosen to close their private placement regimes from that date so the marketing passport will be the only way on reaching investors in those EEA Member States.

AIFMs will also be required to report to the FSA regularly on each AIF under their management. Information required under the requirements set out in Part G of the annex is likely to include trading, investment strategy, geographical and sectoral exposures, markets, principal exposures and other information for each fund. These reporting requirements will be harmonised across the European Union, which will particularly benefit those AIFMs operating in multiple jurisdictions.

<sup>30</sup> Credit Channel effects in the monetary transmission mechanism (2001) S Hall, Bank of England Quarterly Review - Winter

<sup>31</sup> Commonality in hedge fund returns (2012) M Bussiere, M Hoerova a B Klaus, [Banque de France](#) – the authors reviewed existing literature and concluded that of accurate data on hedge funds' leverage limited the ability to assess the risk to financial stability

<sup>32</sup> A Macroeconomic Framework for Quantifying Systemic Risk (2012) Z He and A Krishnamurthy, American Economic Association Working Papers

The use of leverage increases the volatility of an investment and is used in the hope of amplifying investment returns. However, it also increases the risk of major losses for AIFs and of counterparty default for the providers of leverage. During the financial crisis, increasing asset prices increased the value of collateral held which in turn allowed an AIF to obtain more leverage.

### ***Competitiveness benefits***

There is the potential for the Directive to replicate the success of UCITS, creating a strong brand in which investors globally have confidence and which provides an export opportunity for EU AIFMs. At present, from discussions with industry, there is a degree of scepticism within the industry over the potential for establishment of the brand – in part because of the heterogeneity of the funds it covers - but it should be noted that UCITS itself took a number of years to become established. In addition, UCITS is a product Directive – focused on the funds – while AIFMD focuses primarily on the conducts of AIFMs and depositaries.

### ***Market integrity benefits***

A number of the investor protection measures will also help to improve market integrity by addressing liquidity and operational risks. The requirement for effective due diligence in the selection of counterparties strengthens protection against contagion in the event of default.

A consistent approach to transparency in fund accounts will further enhance confidence in market integrity by minimising perception that the accounts can be influenced by external pressures and providing assurance that the accounts are going to the regulator.

Putting in place regulations in order to tackle conflicts of interest also helps reduce the risk of other financial market distortions such as market abuse. There has been high profile litigation involving allegations of insider trading against hedge fund managers in recent years – particularly in the US such as SEC cases against SAC Capital and Galleon Group<sup>33</sup>. Last year, the FSA fined Greenlight Capital for trading on insider information.

Theoretical economic research<sup>34</sup> suggests the lack of regulation and oversight is likely to lead to more incidences of insider trading. Empirical research<sup>35</sup> has found evidence suggesting that hedge fund managers profited from accessing privileged information on investments through participating in syndicated loans and then short-selling those shares.

These benefits would build upon traditional strengths of the UK. Research<sup>36</sup> by Oxera on behalf of CityUK found the UK has established a competitive advantage for fund managers due to its favourable regulatory environment which was seen as apolitical, relatively more flexible and for some managers more attractive than relatively less regulated jurisdictions.

## **Benefits to Investors**

### ***Investor protection***

The Directive introduces greater protection for investors by placing a harmonised set of requirements on AIFMs governing how they may manage AIFs. In practice, the UK's current regime already has many of

<sup>33</sup> Galleon Group is a US hedge fund prosecuted in 2009 for fraud and insider trading. SAC Capital has been under investigation for insider trading since 2010 by US authorities. SEC acted against at least 6 hedge funds for insider trading in 2012

<sup>34</sup> More insiders, more insider trading: Evidence from private-equity buyouts (2010) VV Acharya, Journal of Financial Economics, vol 98, issue 3,

<sup>35</sup> Do hedge funds trade on private information? Evidence from syndicated lending and short-selling (2011) Nadia Massoud, Debarshi K. Nandy, Anthony Saunders and Keke Song Journal of Financial Economics, 2011, vol. 99, issue 3, pages 477-499, [Econpapers](#)

<sup>36</sup> Future Secure? Why Asset Managers Locate in London in The Future of UK Asset Management (2010) City UK

the requirements of AIFMD but the Directive strengthens them and expands the regime to types of funds – principally companies - which are exempted from FSA oversight as funds. UK investors choosing to invest in AIFs managed from overseas will also benefit from the enhanced protection they offer.

It is not possible to quantify the benefits additional investor protection will offer. However, the Madoff fraud is the most prominent recent example of investor loss. Investor loss has been estimated at \$17 bn<sup>37</sup>, though the final figure is likely to be lower than this. The measures in the Directive seek to prevent this type of fraud.

The following table sets out further fund failures or major investor losses and the amounts which have been lost. Please note that only one of these was a UK fund – and it is not suggested that the measures in AIFMD would have necessarily prevented the investor losses; the table is for illustrative purposes.

Fund	Year	Amount lost
Atticus Funds	2008	\$14bn
Wood River Capital	2005	\$5.5m
Satellite Asset Management	2009	\$4.1bn
Park Central Global Hub	2009	\$2.2bn
Weaverling Capital	2009	\$600m
Ascot Partners Limited	2008	\$1.8bn

The majority of AIFMD provisions are designed to protect investors including:

- **Strengthening operational controls and oversight.** Empirical research suggests fund failure due to excessive risk taking is associated with weak operational controls and oversight<sup>38</sup>;
- **Increasing transparency.** Investors have been increasingly requesting greater amounts of transparency from fund managers and more detailed information around liquidity and portfolio attribution, which is addressed within investor disclosure obligations within the directive. One of the potential benefits of the reporting requirements<sup>39</sup> is that some AIFMs could provide new information to investors as a consequence of the regulatory reporting requirements.

This also includes transparency in liquidity management. The Commission identified in its consultation with hedge fund investors<sup>40</sup> concern over transparency in fund liquidity management, redemption policies and the equal treatment of shareholders including side letter practices.

- **Strengthened liquidity management arrangements.** During the financial crisis, when assets were increasingly illiquid, there was extensive restriction of investors' ability to withdraw their investments in full. The liquidity requirements reduce the risk that investors are unable to withdraw their investments - or at least not at a price in line with expectations – at times of market stress. Empirical research<sup>41</sup> from the US Federal Reserve concluded that stocks held by hedge funds were particularly sensitive to changes in aggregate liquidity.

<sup>37</sup> <http://www.bloomberg.com/news/2012-06-25/madoff-investor-appeal-won-t-be-heard-by-supreme-court.html>

<sup>38</sup> Estimating Operational Risk for Hedge Funds: The ?-Score (2008) - S Brown, W Goetzmann, B Liang, C Schwarz - [Econpapers](#)

<sup>39</sup> This point flows from Responding to the new reality – Alternative Investment Fund Managers Directive (2012) Deloitte where 53% of survey respondents said they would do this with examples such as indirect transaction costs and further risk data

<sup>40</sup> European Commission Impact Assessment L1 (2010) European Commission

<sup>41</sup> Liquidity Risk and Hedge Fund Ownership (2011) C Cao and L Petrusek, Finance and Economics Discussion Series, US Federal Reserve

- **Strengthened and more independent fund valuation.** An empirical study<sup>42</sup> of hedge fund failures found that the majority were due to concerns about the determination of fair market value of positions within the fund. A survey of hedge funds by Ernst & Young<sup>43</sup> found that the majority of hedge fund managers outsource the valuation of their portfolios. The same survey suggested that at least 40% of investors and hedge fund managers thought the outsourced administrator was effective in its duties. Only 25% of hedge funds or investors in Ernst & Young survey were confident that administrators can accurately value particularly complex assets.
- **Improved management of conflicts of interest.** A thematic review by the FSA<sup>44</sup> into conflicts of interest within the asset management industry found that many firms had failed to establish an adequate framework for identifying and managing conflicts of interest.
- **Aligning remuneration with fund performance.** The Commission's impact assessment<sup>45</sup> sets out the investor protection benefit when the remuneration of the fund manager is driven by the performance of the fund
- **Stronger depositary protection.** In practice, there are stronger requirements on depositaries to prevent investor loss; and greater liability to investors in the event of loss.

### ***Investor choice***

At an EU level, AIFMD may increase investor choice but the UK already permits funds to be marketed to professional investors under a private placement regime, so the Directive is unlikely to lead directly to increased investor choice.

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<sup>42</sup> Valuation issues and operational risk in hedge funds (2004) C Kundro and S Feffer- Journal of Financial Transformation, 2004, vol 10 – p41-47

<sup>43</sup> Coming of Age: Global Hedge Fund Survey 2011 (2012) Ernst & Young

<sup>44</sup> Conflicts of interest between asset managers and their customers: identifying and mitigating the risks (2012) FSA

<sup>45</sup> AIFMD L1 Impact Assessment (2010) European Commission

## **SECTION B – COSTS AND BENEFITS OF OPTIONS 1-4**

This section considers the specific costs and benefits arising from the choice of sub-threshold regime and relaxing marketing restrictions. The summary of the costs of applying the Directive in options 1- 3 is supported by more detailed analysis in Annex A.

### **OPTION 1 – SUB-THRESHOLD AIFMS SUBJECT TO THE SAME REQUIREMENTS AS ABOVE-THRESHOLD AIFMS**

Under option 1, the Government will apply the requirements in part A in full to sub-threshold AIFMs. The main features of option 1 are therefore:

- AIFMs under all four regulatory regimes must be fully authorised; no use of a discretionary registration-only regime would be permitted for sub-threshold AIFMs;
- All AIFMs are subject fully to the Directive’s requirements; there will be no reduction in requirements for sub-threshold AIFM though in practice FSA would be likely to apply the regime proportionately);
- The current marketing boundary and private placement regime is maintained but supplemented with AIFMD rules.

Option 1 represents maximum gold plating. The impact is greatest on internally managed investment companies, as they have not previously been subject to FSA regulation, and least on NURS and QIS AIFMs, as these are already subject to a high level of regulation, with many rules broadly consistent with UCITS.

#### **Benefits of Option 1**

##### **Strong, consistent investor protection**

Option 1 avoids a “two-tier” regulatory regime, in which investors may be uncertain about the level of protection they receive, which would vary depending upon the assets under management of a firm. There would be a high, consistent standard of protection across regulatory regimes for the investors of both sub-threshold and above-threshold AIFMs.

Professional investors in UCIS are regarded as having an appropriate understanding of the complexities of hedge funds, private equity and venture capital industries, and can take a significant amount of time conducting due diligence before making an investment. While this is not universally the case, they are generally aware of the risks involved in investing with a particular firm. The extent to which they benefit from the additional investor protection in exchange for the additional cost will therefore vary.

By not implementing a registration-only regime, the Government would also avoid the risk of investor detriment as a result of the FSA not having the necessary powers to take action against an AIFM.

##### **Confidence in the regulatory system**

Taken in conjunction with the regulatory reform already underway in the UK, for example the Financial Services Bill, Option 1 would further strengthen the reputation of the UK for strong investor protection.

#### **Costs of Option 1**

##### **Direct costs**

The direct costs of implementing the Directive's requirements under Option 1 are estimated in Annex A and summarised below for above-threshold and sub-threshold AIFMs. The tables contain three separate cost elements:

- The majority of costs are considered on a per AIFM basis. The first two columns estimate the average cost per AIFM under each of the four regulatory regimes. The figures are derived by summing the estimated cost per AIFM for each of the elements in Annex A;
- Some additional transparency costs are considered on a per AIF basis. The third and fourth columns provide the total transparency costs accruing to the AIFs under each of the four regulatory categories; and
- Depository costs are estimated as a proportion of total assets under management for each of the four regulatory categories.

The final two columns in the tables provide the total estimated costs for each of the four regulatory categories. These are then summed to estimate a total estimated cost for industry.

#### Above-threshold AIFMs

The direct cost of implementing the Directive remains largely the same for options 1-3 as the Government does not have discretion over the elements to apply:

Provision	Cost per AIFM		Total AIF Reporting Costs One-Off (£000)	Total AIF Reporting Costs Ongoing (£000)	Depository ongoing costs (£000)	Total Cost	
	One-off cost (£000)	Ongoing cost (£000)				One-off cost (£000)	Ongoing cost (£000)
<b>NURS</b>	320-503	543-759	2,336-2,648	1,402-2,181	45,128-180,510	17,395-26,302	72,054-218,346
<b>QIS</b>	320-503	539-748	188-213	113-175	2,120-8,480	1,149-1,722	3,848-10,898
<b>UCIS</b>	561-894	1206-1676	5,926-6,715	3,477-4,832	221,317-797,741	197,839-312,565	637,160-1,375,765
<b>Int Invest Company</b>	486-760	926-1300	48-56	632-787	13,178-39,534	3,935-6,139	133,261-207,973
<b>TOTAL</b>						220,318-346,728	846,323-1,812,981

#### Sub-threshold AIFMs

For sub-threshold AIFMs, option 1 represents the highest cost option and involves significant gold plating. Costs are as follows:

Provision	Cost per AIFM		Total AIF Reporting Costs One-Off £000	Total AIF Reporting Costs Ongoing £000	Depository ongoing costs (£000)	Total Cost	
	One-off cost (£000)	Ongoing cost (£000)				One-off cost (£000)	Ongoing cost (£000)
<b>NURS</b>	233	436	693	441	3,231	3,026	8,034
<b>QIS</b>	233	436	3	2	61	236	499
<b>UCIS</b>	419	951	4,238	2,831	27,144	157,696	377,912
<b>Int Invest Company</b>	433	835	300	188	8,228	32,746	71,042
<b>TOTAL</b>						193,704	457,487

#### Total costs



Total costs include the costs to above threshold AIFMs, the costs to sub-threshold AIFMs and the following additional costs:

Activity	One-off Cost £m	Ongoing Cost £m
FSA costs	13.4	
Costs to depositaries	1.8	3.5
Capital Shortfall	104	
Private Equity Fund costs	7-13	33-38

For subsequent years, the ongoing costs are applied assuming that there is no underlying change to the base population of AIFMs. A five year period has been chosen as beyond this, it is anticipated that AIFMD will be reviewed at European level. Assuming costs are at midpoint of the estimates, discounted present value costings are:

Year	0	1	2	3	4	5	Total
Low estimate (£m)	527	1,295	1,251	1,208	1,168	1,128	6,577
High estimate (£m)	672	2,233	2,158	2,085	2,014	1,946	11,110
Mid-point estimate (£m)	600	1,764	1,704	1,647	1,591	1,537	8,843

As noted earlier, for the purpose of this impact assessment, the costs are assumed to be borne by the AIFM but in practice the majority may well be passed on to investors.

## Competitiveness

Feedback to the Treasury's discussion paper argued strongly that a decision to apply all AIFMD requirements to all sub-threshold AIFMs would place the UK at a significant competitive disadvantage relative to other Member States. This is further supported by a survey from Open Europe<sup>46</sup> in which, almost unanimously, fund managers considered the Directive's 'one size fits all' approach to be inappropriate.

From discussions with industry, it is likely there would be relocation of AIFMs and restructuring as a result of option 1.

**Sub-threshold UCIS** are the category of AIFM most likely to relocate. Hedge funds AIFMs in particular are highly mobile, as are Private Equity AIFMs. Some UCIS AIFMs would move to other EU Member States with more proportionate regimes, others would move outside the EEA and market to professional investors through private placement until at least 2018. In the latter case, the AIFMs may well delegate some portfolio and risk management back to the UK to the extent allowed under the Directive, which would mitigate the loss of economic activity.

Some sub-threshold **internally managed investment companies** are also likely to relocate. The impact of this category of AIFM may be greater on this category as internally managed investment companies have not previously been subject to FSA funds regulation.

**NURS and QIS** are UK regimes and therefore AIFMs managing NURS and QIS AIFs will not be able to relocate. It is possible that there will be a reduction in their uptake, though given these regimes are already subject to greater regulation in any case, this is less likely. Another possibility is that over time, there will be a shift from NURS to UCITS funds, for which the costs may be somewhat lower, at least until the next UCITS Directive is implemented. UCITS funds are similar but more restrictive in terms of

<sup>46</sup> The EU's AIFM Directive: Likely Impact and the Best Way Forward (2009) OpenEurope, Matt Perrson

permissible investments, for example property investments are not permitted, so this may have the effect of restricting retail investor choice. UCITS is an EU regime so some funds could potentially move out of the UK.

### **Investment**

Sub-threshold private equity and venture capital AIFMs, in particular, tend to manage venture and growth funds, undertaking early stage investments. It is possible that a reduction in the number of such funds based in the UK could reduce the amount invested in the UK proportionately, though in practice investors preferring to invest in UK companies may well continue to do so. In addition, applying the private equity provisions of the Directive to sub-threshold firms could also constrain their investment strategies.

## OPTION 2 – SUB-THRESHOLD AIFMS SUBJECT TO MINIMUM DIRECTIVE REQUIREMENTS

Under option 2, the Government would apply only the minimal Directive requirements to sub-threshold AIFMs. The main features of option 2 are therefore:

- Only above-threshold AIFMs under the four regulatory regimes would be authorised; sub-threshold AIFMs would be subject to registration only – with a very basic level of FSA oversight;
- Sub-threshold AIFMs would be largely exempt from the Directive’s other requirements unless they opted to become fully authorised in order to benefit from the Directive passporting regime; and
- The current marketing boundary and private placement regime would be maintained.

The UK already has a strong regulatory regime and option 2 would remove nearly all current requirements for sub-threshold NURS, QIS and UCIS AIFMs. It is therefore highly deregulatory. For internally managed investment companies, option 2 would represent the smallest possible regulatory burden.

### Benefits of Option 2

#### Direct costs

Ongoing costs for NURS, QIS and UCIS AIFMs would be reduced as a result of no longer being authorised and subject to regulation under the Financial Services and Markets Act. As noted in Part B, many of the principles behind the requirements of AIFMD already apply in domestic legislation, so these costs would be removed. Where professional investors undertook their own due diligence, this would allow them to ensure a level of protection that met their needs.

It is not possible to quantify the reduction in direct costs resulting from this approach at this time because:

- AIFMs would choose to apply an uncertain level of investor protection safeguards in any case in order to gain the confidence of investors;
- Investors would be required to undertake greater due diligence for sub-threshold AIFMs and the costs of this are highly uncertain; and
- The costs of applying existing regulation are unknown and it would be disproportionate to seek to determine them unless it is likely the Government will take this approach.

However, for illustrative purposes a rough estimate can be made. Internally managed investment companies are entirely new to regulation by FSA as funds whereas NURS / QIS and UCIS AIFMs, and external managers of investment companies, are already authorised. By comparing the difference in costs for these regimes under option 1, a very crude indication of possible costs could be upto £200k per AIFM in the first year and £400k on an ongoing basis plus depositary costs of 12.5-20 bps

#### Competitiveness

For sub-threshold **UCIS AIFMs**, the removal of existing regulation could potentially make the UK more competitive, lowering the regulatory burden for sub-threshold AIFMs and allowing greater flexibility. It could also lower barriers to entry, allowing for greater competition. A number of respondents to the Treasury’s discussion paper supported such an approach. We believe a number of other Member

States will choose this option – and the United States has an equivalent of a *de minimis* regime for sub-threshold hedge fund AIFMs.

However, this would need to be offset against the reputation of the UK regulatory regime. The UK currently has a strong UCIS AIFM sector with its current level of investor protection; and it is likely that there is professional investor support for a baseline level of protection, which this would remove. For this reason, the majority of respondents to the Treasury's discussion paper, including the major trade bodies, did not argue for the introduction of a *de minimis* regime for UCIS AIFMs.

For sub-threshold **internally managed investment companies**, application of the minimum Directive requirements would maintain their competitiveness as an investment opportunity.

## Growth

Finally, some respondents have indicated during the course of consultation that a *de minimis* regime would be conducive for small AIFMs to start-up and grow up to the Assets Under Management threshold.

## Costs of Option 2

### Direct costs

#### Above-threshold AIFMS

The costs for above-threshold AIFMs would be the same as for Option 1.

#### Sub-threshold AIFMs

Provision	Cost per AIFM		Total AIF Reporting Costs One-Off £000	Total AIF Reporting Costs Ongoing £000	Depositary ongoing costs (£000)	Total Cost	
	One-off cost (£000)	Ongoing cost (£000)				One-off cost (£000)	Ongoing cost (£000)
<b>NURS</b>	£11	£33	-	-	-	£114	£328
<b>QIS</b>	£11	£33	-	-	-	£11	£33
<b>UCIS</b>	£13	£38	-	-	-	£4,636	£13,725
<b>Int Invest Company</b>	£11	£33	-	-	-	£856	£2,461
<b>TOTAL</b>						£5,618	£16,547

### Total costs

Total costs include the costs to above threshold AIFMs, the costs to sub-threshold AIFMs and the following additional costs:

Activity	One-off Cost £m	Ongoing Cost £m
<b>FSA costs</b>	13.4	
<b>Costs to depositaries</b>	1.8	2
<b>Capital Shortfall</b>	£104	
<b>Private Equity Fund</b>	4-10	22-27

<b>costs</b>		
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For subsequent years, the ongoing costs are applied assuming there is no underlying change to the base populations of AIFMs. A five year period has been chosen as beyond this, it is anticipated that AIFMD will be reviewed at European level. Assuming costs are at the midpoint of the estimates, discounted present costings are:

Year	0	1	2	3	4	5	Total
<b>Low estimate (£m)</b>	245	856	827	799	772	746	4,247
<b>High estimate (£m)</b>	377	1,795	1,735	1,676	1,619	1,565	8,766
<b>Mid-point Estimate (£m)</b>	311	1,326	1,281	1,238	1,196	1,155	6,507

\*All figures given at present value on basis of 3.5% p.a. discount and is rounded to the nearest £m

### Investor protection

Reducing substantially the current regulatory requirements for NURS, QIS and UCIS AIFMs would represent a significant reduction in investor protection for the reasons set out in Part B. This would be particularly significant for retail investors in NURS, who typically would not be in a position to undertake their own due diligence.

Applying only the minimum Directive requirements for sub-threshold internally managed investment companies would miss the opportunity to provide a consistent harmonised approach to regulation, with investors not benefitting from the additional protection of FSA authorisation. However, this would largely maintain the status quo, with company law, listing rules where appropriate, and other EU Directives, including the Prospectus Directive, providing the current level of protection.

### Competitiveness

NURS and QIS AIFMs would not realistically relocate as the schemes are domestic. But reducing the regulatory requirements is likely to reduce investment:

- Professional investors choosing to invest in the regimes do so on account of the strong investor protection offered (as well as other benefits including pooling). Reducing this protection for sub-threshold AIFMs may well make the schemes less attractive rather than more unless industry put its own safeguards in place;
- In practice, over two thirds of retail funds are already UCITS funds and applying these rules may tip the balance further towards investment in UCITS funds which may not necessarily be managed from the UK. This could also reduce investment in assets, such as property, that are not permissible under UCITS;
- In line with its investor protection remit, the FSA would be obliged to take steps to protect retail consumers. At the least, sub-threshold NURS AIFMs would be obliged to place prominent warnings over the reduced level of regulation, which would make the products unattractive, but there would be a case for going further and restricting their marketing to retail investors.

In practice QIS AIFs are often used as pooling vehicles attracting large volumes of funds, so at any given time, there are very few sub-threshold QIS AIFMs; presently we believe there is only one. Any new QIS AIFM would seek to rapidly grow assets to above threshold so we believe a reduced regulation sub-threshold regime would have very limited commercial relevance.

### **Confidence in the regulatory system**

It is likely that a substantial reduction in investor protection for NURS, QIS and UCIS AIFMs would lead to greater investor detriment. The FSA would have limited powers to address this under registration-only arrangements and this could undermine investors' confidence in the UK regulatory approach.

### **OPTION 3 – PREFERRED OPTION FOR APPLICATION OF DIRECTIVE TO SUB-THRESHOLD AIFMs**

Under option 3, the Government would apply a regime with a level of regulation between options 1 and 2. Option 3 represents introducing a sub-threshold regime as close as possible to the status quo. From initial discussions with industry and the FSA, and responses to its earlier Discussion Paper, the Government considers this to be optimal; maintaining a strongly competitive UK regime, promoting investor choice and ensuring appropriate protection for investors, especially retail investors. The main features of option 3 are:

- Sub-threshold internally managed investment companies AIFs would be subject to the AIFMD minimum requirements, establishing a regime resembling the status quo as closely as possible, which the Government considers to have appropriate safeguards through company law, the Prospectus Directive where relevant and other legal requirements;
- Sub-threshold UCIS AIFMs, together with sub-threshold NURS and QIS AIFMs and the external management of investment companies, would continue to be authorised and subject to arrangements closely resembling the status quo, which the Government considers to provide professional, high net worth and sophisticated investors with an appropriate level of protection. No additional AIFMD requirements would be placed upon these AIFMs.

The Government's preferred option has been modified as a result of the consultation. At the time of the consultation, the Government envisaged applying most of the AIFMD requirements to sub-threshold NURS and QIS AIFMs. This represented a degree of gold plating, justified on the basis of avoiding a two-tier system of investor protection within the same regulatory regime, which retail investors in particular would be unlikely to understand.

However, consultation feedback was strongly that this would impose extra costs on sub-threshold NURS and QIS AIFMs. Given the current NURS regime is considered appropriate protection for retail investors, the Government has decided not to modify it for sub-threshold AIFMs at this time, and instead to review it upon the introduction of UCITS V, which NURS is designed to replicate.

#### **Benefits of Option 3**

##### **Investor protection**

Option 3 maintains the status quo and takes a proportionate approach to investor protection:

- Flexibility and a lower regulatory burden is maintained for sub-threshold UCIS AIFMs, which may be marketed to high net worth and sophisticated investors only. The level of regulation is higher than the Directive minimum but ensures a baseline level of protection;
- Sub-threshold NURS and QIS AIFMs may also benefit from status quo levels of regulation. Although this is a lower level of protection that offered by full-scope AIFMs, their regulation still offers strong investor protection benefits, akin to those offered by the retail-focused UCITS Directive.
- Sub-threshold internally managed AIFMs would retain existing investor protection but not be subject to additional regulatory cost. There is no gold plating for sub-threshold internally managed investment companies;

##### **Competitiveness**

Option 3 offers the opportunity to maintain and enhance competitiveness. Sub-threshold AIFMs would be largely subject to existing levels of regulation which response to Treasury's discussion paper largely considers to strike an appropriate balance between investor protection and cost;

### Costs of Option 3

#### Direct costs

While option 2 is substantially deregulatory, option 3 represents the status quo. However, the deregulatory elements of option 2 have not been quantified. Quantified costs for option 3 are therefore the same as for option 2.

### Costs of Option 3

#### Direct costs

##### Above-threshold AIFMS

The costs for above-threshold AIFMs would be the same as for Option 1.

##### Sub-threshold AIFMs

Provision	Cost per AIFM		Total AIF Reporting Costs One-Off £000	Total AIF Reporting Costs Ongoing £000	Depositary ongoing costs (£000)	Total Cost	
	One-off cost (£000)	Ongoing cost (£000)				One-off cost (£000)	Ongoing cost (£000)
NURS	11	33	-	-	-	£114	£328
QIS	11	33	-	-	-	£11	£33
UCIS	13	38	-	-	-	£4,636	£13,725
Int Invest Company	11	33	-	-	-	£856	£2,461
<b>TOTAL</b>						<b>£5,618</b>	<b>£16,547</b>

#### Total costs

Total costs include the costs to above threshold AIFMs, the costs to sub-threshold AIFMs and the following additional costs:

Activity	One-off Cost £m	Ongoing Cost £m
<b>FSA costs</b>	13.4	
<b>Costs to depositaries</b>	1.8	2
<b>Capital Shortfall</b>	104	
<b>Private Equity Fund costs</b>	4-10	22-27

For subsequent years, the ongoing costs are applied assuming there is no underlying change to the base populations of AIFMs. A five year period has been chosen as beyond this, it is anticipated that AIFMD will be reviewed at European level. Assuming costs are at the midpoint of the estimates, discounted present costings are:



Year	0	1	2	3	4	5	Total
Low estimate (£m)	245	856	827	799	772	746	4,247
High estimate (£m)	377	1,795	1,735	1,676	1,619	1,565	8,766
Mid-point Estimate (£m)	311	1,326	1,281	1,238	1,196	1,155	6,507

\*All figures given at present value on basis of 3.5% p.a. discount and rounded to the nearest £m.

**In order to determine business costs, the one-off costs to the Financial Services Authority are excluded to obtain business net present value of £6,493m**

### Investor Protection

Under option 3, there is a “two-tier” regulatory regime for retail and other investors in NURS and QIS regulated funds. However, the sub-threshold NURS AIFMs, which are open to general retail investors, still offer a high level of investor protection. The FSA may require sub-threshold NURS AIFMs to declare the more limited regulatory regime they are under in their prospectuses.

### Competitiveness

The opportunity would not be taken under Option 3 to reduce regulatory requirements for UCIS, NUS and QIS AIFMs. As noted, we believe a number of other Member States may choose to implement a registration-only regime for funds targeted only at professional investors. However, the Government considers the investor protection and reputational benefits of maintaining a proportionate level of investor protection to outweigh the direct costs of the regulation.

## OPTION 4 – AS OPTION 3 BUT WITH MARKETING RESTRICTIONS RELAXED

EU regulations categorise investors as either professional or retail. The UK AIF marketing regime for funds offers considerable flexibility for professional investors, together with types of retail investors who are deemed sufficiently sophisticated or with a high net worth. For other retail investors, however, there is an emphasis on ensuring the products are appropriate through:

- Sufficient liquidity to ensure investors may access their funds easily at a fair price;
- Appropriately managed investment risk – including sufficient diversity to reduce exposure to any single poorly performing asset; and limits on exposure and leverage; and
- Transparency – to give investors a greater understanding of what they are buying.

The NURS regime is designed to achieve this through restrictions on investment powers - so NURS AIFs may already be marketed to all investors – including retail investors. Investment companies are suitable for retail investment in a different way; investment companies are listed on a primary market, which typically provides them with some liquidity, and there is disclosure of investment strategy and other material features through their prospectuses.

QIS rules have much more limited restrictions, for example they may invest in relatively illiquid or non-diversified products. UCIS schemes typically have no such restrictions.

Under option 4, the restrictions on NURS and QIS AIFs being marketed to retail investors would be removed.

### Benefits

A key benefit of broadening the marketing regime is that there would be greater choice for retail investors, with a wider range of permissible investment strategies. For example, private equity and hedge funds could be marketed to retail investors; retail investors' access to such funds is currently very limited.

Riskier strategies with higher returns may attract more investment from retail investors into UK AIFMs in the short term, boosting the profitability of AIFMs. It is unlikely that UK AIFMs would be permitted to market such schemes to other EU Member States, so the investment would come from UK investors.

### Costs

This option doesn't alter substantially the direct costs set out in option 3. There may, however, be an increase in mis-selling of inappropriate products to retail investors. The FSA has recently consulted over misselling<sup>47</sup> of similar products to retail investors and it is likely this would cause further misselling.

Respondents to the Treasury discussion paper were broadly not in favour of removing marketing restrictions from the NURS and QIS schemes.

<sup>47</sup> <http://www.fsa.gov.uk/library/policy/cp/2012/12-19.shtml>

## PART D – FURTHER IMPACT TESTS

### Statutory Equality Duties Impact Test

The Government has considered its obligations under the Equalities Act 2010. We do not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under that act.

### Small Firms Impact Test

In implementing the Directive for small firms in a way that reduced regulatory burdens, the Government could decide to apply the *de minimis* registration-only approach set out in option 2 for microbusinesses only. Option 2 sets out the costs and benefits of this approach:

- The regulatory burden on small AIFMs would be reduced, allowing greater flexibility and reduced costs, which would be passed on to retail investors;
- Investor protection would be significantly reduced, and in the case of NURS, exposing retail investors to significant risk;
- Confidence in the UK regulatory regime would be undermined; in the long term potentially leading to a reduction in assets being managed within the UK; and
- FSA is likely to require microbusinesses to publish a prominent warning that their products weren't subject to the same protection as those managed by non-microbusiness AIFMs. While some institutional and sophisticated investors may accept this, this may well put microbusiness retail AIFMs at a disadvantage to other AIFMs.

For these reasons, we believe applying an exemption for microbusinesses is prejudicial to their interests and those of consumers. This position was supported by feedback to the consultation, where there were no responses in favour of reducing regulatory requirements for sub-threshold AIFMs from the status quo. This included feedback from sub-threshold AIFMs.

However, it was noted that two categories of sub-threshold UCIS AIFMs – managers of property funds and managers of EIS schemes – were not being subjected to status quo arrangements as intended. This is being rectified in the final regulations.

Consultation feedback has suggested that a significant proportion of sub-threshold UCIS AIFMs, mainly private equity and real estate funds are microbusinesses. Therefore, 20% of the UCIS sub-threshold population have been estimated as microbusinesses. Industry bodies<sup>48</sup> have indicated to us that there are 2 NURS sub-threshold AIFMs that are microbusinesses and 15 Venture capital trusts that would fit the microbusiness category.

Under the preferred option, there is no gold plating beyond status quo for microbusinesses, with costs arising from applying for changes in FSA permission and reporting / transparency. Costs are therefore:

	Provision	Cost per AIFM £000		Aggregated Cost £000			Total Cost £000	
		One-off cost	Ongoing cost	One off AIF costs	Ongoing AIF Costs	Ongoing Depository Costs	One-off cost	Ongoing Cost
Number of Subthreshold AIFMs								

<sup>48</sup> This followed from discussions with the Investment Management Association and the Association of Investment Companies

2	NURS	11	33	0	0	0	22.83	65.63
0	QIS	11	33	0	0	0	0.00	0.25
73	UCIS	13	38	0	0	0	927.20	2745.00
15	Int Non-CIS AIF	11	33	0	0	0	171.25	492.19
90	TOTAL						1,121.3	3,303.1

Costs to microbusinesses are therefore estimated as £4.4m on a one-off and an ongoing basis. On a present value basis, this will cost an additional £16m over 5 years.

### **Human Rights Impact Test**

The proposals in this impact assessment are compatible with the Convention rights.

### **One In Two Out**

The Government is not introducing gold plating above the status quo in its preferred option, it is only levelling up to existing requirements, so the cost of gold plating under the Government's One In Two Out policy is £0. The Directive is being introduced for the purpose of managing systemic risk, as set out elsewhere in this Impact Assessment, and in order to comply with EU legislation.

## **A Authorisation & registration**

### **Option 1**

Under AIFMD, EEA AIFMs but be authorised, or in some cases, registered. In order to be authorised, AIFMs must:

- **Take legal advice on the regulatory regime they should comply with;**
- **Supply FSA with data; and**
- **Respond to FSA questions / challenges.**

Investment companies will need be authorised for the first time and for simplicity we have assumed that that other AIFMs will apply for changes in permission only based on existing authorisation; in practice a small number of AIFMs from other categories are likely to be authorised as well but it would be disproportionate to consider these at this stage. These include AIFMs which are entering the UK and AIFMs which are significantly restructuring.

The AIFM applying for authorisation will need to set out all functions which are delegated and provide a rationale for each delegated activity. AIFMs will also need to satisfy FSA capital requirements as well as ensuring private indemnity insurance arrangements are in line with directive requirements.

We expect non-staff costs to be a combination of legal and professional fees to support analysis of whether an AIFM is above or below threshold – and to support preparation of the necessary documentation. This is supported by feedback from industry bodies and compliance specialists. Based upon this feedback, we have also increased estimated costs for this support derived from the FSA survey data by £5k-10k.

On average, applying for variation of permission is likely to be cheaper than applying for authorisation from scratch - as the AIFM is familiar with the process and has already supplied data, though this will depend upon the number of AIFs being managed and the complexity of the funds.

The Directive sets out minimum requirements for an AIFM registering under the Directive and FCA will be partially grandfathering current arrangements so the requirements on AIFMs in applying for a variation in permission should be broadly similar to those for AIFMs which are registering.. We therefore assume as a rough estimate that the costs of registering and applying for a variation in permission to be the same

Consultation feedback with firms that managed NURS AIFs has suggested that the cost of variation of permission for subthreshold NURS is likely to be significantly lower than for above threshold AIFMs. We have assumed this to be the case for QIS and NURS AIFMs as well.

Industry feedback has also highlighted further uncertainty over the costings, which is reflected in the broad range of the estimates. Reasons for uncertainty include the need for some AIFMs to take time (and legal advice) in considering whether they are in scope of the Directive, and the need for many AIFMs will wish to consider whether they restructure – either to change domicile, or to merge or separate AIFMs. This is considered particularly challenging for multi-managers funds, for which considering of who is the AIFM rests on split of responsibilities.

The caveats in section A also apply, with costs dependent upon whether AIFMs restructure, move between regulatory categories and enter or leave the EU.

Operating Requirement / Regime (& assumption)	Above-threshold AIFMs		Sub-threshold AIFMs	
	One-off cost per AIFM – staff days	Other costs (£000)	One-off cost per AIFM – staff days	Other costs (£000)
Vary permission NURS, QIS x1 UCIS x1.5	20-60	25-70	20	11
Authorisation Internal Invest Companies x1	40-50	38-65	40	38

## Option 2

All above-threshold AIFMs would be authorised but all sub-threshold AIFMs would be subject to a de minimis registration regime only. Firms would potentially incur legal and potential independent valuation fees in determining whether they were and remained sub-threshold and hence eligible for the registration regime. Registered firms will also be expected to make clear to their consumers that they are not authorised by the Financial Services Authority which may result in some additional costs.

Registration would be strongly deregulatory for sub-threshold NURS, QIS and UCIS AIFMs, together with the AIFMs of externally managed investment companies, which are already authorised. However, as these are already authorised there would be some minimal costs in applying for registration. For internally managed investment companies, there will be the costs of applying for registration from scratch.

Applying for registration would be significantly less of a regulatory burden than applying for authorisation. AIFMs will need to take legal advice on whether they comply with the sub-threshold AIFM regime – and discussions with industry suggest that some investment companies may restructure themselves to become internally managed if the sub-threshold AIFMs regime involves sufficiently less cost. And the AIFMs will have to provide basic information to FSA – there will not be an ongoing process of scrutiny prior to approval however.

Industry feedback has suggested that while registration would certainly be cheaper than authorisation, legal fees should not be underestimated, for example in demonstrating to FSA that directors are compliant with the requirements for registration. The estimated costs reflect this feedback. There may also, on an ongoing basis, be the need to obtain legal advice in the calculation of assets for the purposes of the threshold and what measures may need to be in place as a result of a temporary breach. However, these costs associated with this are assumed not to be significant across the population as a whole.

Operating Requirement / Regime (& assumption)	Above-threshold AIFMs		Sub-threshold AIFMs	
	One-off cost per AIFM – staff days	Other costs (£000)	One-off cost per AIFM – staff days	Other costs (£000)
Vary permission NURS, QIS x1	20-60	25-70	n/a	n/a

Operating Requirement / Regime (& assumption)	Above-threshold AIFMs		Sub-threshold AIFMs	
	One-off cost per AIFM – staff days	Other costs (£000)	One-off cost per AIFM – staff days	Other costs (£000)
UCIS x1.5				
<b>Authorisation</b> Internal Invest Companies	40-50	38-65	n/a	n/a
<b>Registration</b> (all) NURS, QIS x1 UCIS x1.5 Int. Inv Co x1	n/a	n/a	15	6

### Option 3

Maintenance of a regime that as closely as possible mirrors the status quo would require sub-threshold NURS, QIS and UCIS AIFMs, together with the AIFMs of externally managed investment companies, to remain authorised. Internally managed investment companies would be permitted to use the registration-only regime.

Costs for sub-threshold AIFMs are likely to be less than for larger ones; as they are likely to be less complex to authorise or register. We therefore take the lower bound of costings to be the estimated cost for sub-threshold AIFMs. Based on the other estimates in options 1 and 2, the monetised costs would therefore be:

Operating Requirement / Regime (& assumption)	Above-threshold AIFMs		Sub-threshold AIFMs	
	One-off cost per AIFM – staff days	Other costs (£000)	One-off cost per AIFM – staff days	Other costs (£000)
<b>Vary permission</b> NURS, QIS, x1 UCIS x1.5	20-60	25-70	15	6
<b>Authorisation</b> Internal Invest Companies x1	40-50	38-65	n/a	n/a
<b>Registration</b> (internal Invest Companies) x1	n/a	n/a	15	6

### SUMMARY

Regulatory Regime	Size	Option 1 One-off cost per AIFM (£000)	Option 2 One-off cost per AIFM (£000)	Option 3 One-off cost per AIFM (£000)
NURS	Above	32-92	32-92	32-92
	Sub	18	11	11

<b>Regulatory Regime</b>	<b>Size</b>	<b>Option 1 One-off cost per AIFM (£000)</b>	<b>Option 2 One-off cost per AIFM (£000)</b>	<b>Option 3 One-off cost per AIFM (£000)</b>
<b>QIS</b>	Above	32-92	32-92	32-92
	Sub	18	11	11
<b>UCIS</b>	Above	51-145	51-145	51-145
	Sub	36	13	13
<b>Int Invest Company</b>	Above	52-83	52-83	52-83
	Sub	52	11	11



## **B Operating requirements**

### **Option 1**

Under option 1, the Government would require all AIFMs to apply in full the AIFMD operating requirements. In practice, many AIFMs already have arrangements in place to a greater or lesser extent – and a number of the requirements are inter-related – so any breakdown of costings is only likely to be a high level approximation.

The principles behind these provisions already represent good practice for well-run AIFMs and this is reflected in the best practice guidance of the main industry bodies as well as FSA rules relevant to their existing authorisation. Many of the requirements are already also present in the FSA rules governing NURS and QIS.

However, the AIFMD requirements are in some cases more prescriptive, and for investment companies in particular, many of them represent a formal requirement for the first time. The level 2 implementing regulations set out further detail about these requirements which the FCA will take into account in their supervisory approach.

Following limited response to the FSA firm survey to differentiate between costs to AIFMs governed by each the four current regulatory regimes, we spoke to industry bodies, advisors and conducted secondary research. This has helped inform and revise our estimates.

Furthermore, a number of AIFMs manage more than one type of AIF. However, from a high-level gap analysis comparing the Directive with the existing UK regulatory regime, and feedback from the other surveys and consultations, we make some further qualitative and quantitative assumptions around the requirements:

- **Establishing permanent compliance.** All authorised AIFMs must establish a permanent compliance. This function must be separate from other functions and activities of the AIFM. The purpose of the compliance function is to detect and remedy any risk of failure by the AIFM to comply with its obligations under AIFMD. At the time of the interim impact assessment, there were industry concerns about the extent of restructuring required, particularly if the implementing measures required separate functions to be established in order to be hierarchically separate. Some respondents to the FSA discussion paper on this issue felt that if a separate compliance function should be set up, then it would require a separate internal audit function.

From the FSA survey data, it appears that the cost of compliance is broadly proportional to the assets under management. The cost is likely to vary with size and complexity of AIFs and some advisors have indicated that this may require establishing a separate compliance department if appropriate<sup>49</sup>.

Discussions with legal advisors suggest that many fund managers will need to formalise their existing arrangements in order to meet AIFMD standards which will result in one-off costs. Industry feedback has suggested there will be a need for restructuring in some AIFMs in relation to compliance functions which may not be fully captured by reporting to the FSA survey, particularly in commissioning legal advice although some AIFMs can take advantage of intra-group legal Counsel. Following the publication of the level 2 implementing measures, analysis by Ernst & Young<sup>50</sup> also suggested that most AIFMs may have to invest substantially in their governance and controls framework after reviewing their operating models. We have therefore departed from FSA survey data by allowing £50k in one-off costs for an element of restructuring.

<sup>49</sup> 10 Practical Key AIFMD Actions for Managers (2012) [Berwin Leighton Paisner](#)

<sup>50</sup> Alternative Investment Funds: Challenging Months Ahead (2013) Ernst & Young

Consultation feedback also suggests that the extent to which AIFMs will need to update their policies and procedures for which the final cost is likely to vary depending upon the complexity of the fund. We have therefore made provision for 5-15 additional one-off staff days for most categories of AIFMs compared to the original impact.

We have estimated variations in cost for the compliance function between the different regulatory regimes:

- Consultation feedback has suggested that internally managed investment companies will incur greater costs for their compliance functions as they are new to the regulatory regime;
- Consultation feedback has noted that NURS and QIS AIFMs in particular are already subject to stringent requirements under regimes designed to mirror UCITS (and some manage UCITS funds as well) though AIFMD will create some new burdens;
- Some UCIS AIFMs will be subject to MiFID requirements which already place some obligations. However, hedge fund AIFMs may also face somewhat higher costs on account of the complexity of their strategies.

We have therefore estimated the cost to NURS and QIS AIFMs on average as being 0.3 times that for UCIS AIFMs, with the cost to internally managed investment companies being 1.5 times that for UCIS AIFMs.

The larger AIFMs are in practice likely to already have central compliance functions so therefore are less likely to need restructuring, particularly as a consequence of managing UCITS funds with similar regulatory requirements, but there will be one-off costs in updating compliance policies and preparing for AIFMD.

- **Establish internal audit functions**

All authorised AIFMs must establish a permanent internal audit function. The FSA<sup>51</sup> found that larger firms are likely to already have independent functions established in this area - particularly where they are authorised under MIFID. This means the costs are likely to be lower for UCIS firms which was a significant source of uncertainty at the time of the impact assessment. *The range of one-staff days has since been narrowed to 20-25 days. We have also copied over multipliers of 0.3 for NURS, QIS and UCIS.*

The FSA<sup>52</sup> found that larger firms are likely to already have independent internal audit functions established in this area, where they are authorised under MIFID. This means the costs are likely to be lower for UCIS firms.

- **Ensuring suitable electronic systems are in place for a timely and proper recording of portfolio transactions and subscription or redemption orders.** The level 2 European Commission impact assessment highlighted that this was particularly important for depositories to conduct their cash monitoring purposes, particularly as financial instruments were mostly in the form of electronic records which are then required for securities settlement systems.

This may well be more expensive for hedge funds than for other regulatory categories, on account of the potential complexity in arrangements and frequency in trading. However, this is partly offset by hedge funds already having arrangements in place on which to build, and for the UCIS category as whole by the inclusion of AIFMs for closed-ended AIFs that trade infrequently

<sup>51</sup> FSA Cost Benefit Analysis into Mifid (2009) [FSA](#)

<sup>52</sup> FSA Cost Benefit Analysis into Mifid (2009) [FSA](#)

and will not need to handle subscriptions & redemptions. These include private equity and venture capital funds, although advisory bodies suggest that some of these AIFMs are upgrading paper records by installing IT infrastructure.

For other regulatory categories, internally managed investment companies will not need to handle subscriptions & redemptions, and NURS and QIS AIFMs are likely to have similar arrangements already in place. We therefore assume costs for NURS, QIS and internally managed investment companies to be half the costs for UCIS AIFMs.

- **Putting in place standardised accounting policies to allow for depositary verification of securities;** The implementing measures set out the specific accounting procedures which will be largely set out in FSA rules. The accounting procedures will ensure that all assets and liabilities of the AIF can be directly identified at all times and ensure that the net asset value of each AIF is accurately calculated on the basis of the applicable accounting rules and standards. Industry feedback suggests the main issues for AIFMs will be where AIFMD accounting requirements conflict with current national requirements. Some firms<sup>53</sup> were particularly concerned with how the level 2 implementing regulations fit with international standards, for example a requirement that AIFMs adopt the same end date.

It is possible investment companies may face further cost from accounting policies and procedures as they will need to publish financial statements in line with the implementing regulation alongside accounts published to comply with listing requirements. On account of potentially having to publish these two sets of accounts, we estimate the cost to investment companies as being 1.5x that for NURS, QIS and UCIS AIFMs

- **Putting in place due diligence arrangements** which are proportional to the nature, scale and complexity of the assets invested in. Many AIFMs will have in practice have due diligence procedures that will need updating, although reviewing the estimates with firms revealed that most UCIS and NURS firms already had in place stringent due diligence requirements. This is supported by survey evidence from Ernst & Young which suggested 96% of UCIS respondents already have a due diligence process in place. This means that the costs are likely to be minimal for most UCIS firms. We have therefore revised the UCIS, QIS and NURS costs to be 0.3 times those for investment companies.
- **Putting in place arrangements to ensure conflicts of interest with counterparties and prime brokers are appropriately managed;** if counterparties are also used for custody services, that they be either replaced or separated from the AIFs' depositaries functionally and hierarchically. This is relevant primarily to hedge funds. The Deloitte survey suggested that at least a quarter of fund managers currently use their prime broker for custody services;
- **Putting in place procedures to ensure fair treatment of investors;** The initial rules required AIFMs to describe how an AIFM would ensure fair treatment of investors. Most funds already authorised should already be in compliance through the general principles approach<sup>54</sup>. There is a key interaction between the principles and the requirements to manage conflicts of interest here which means that there is an element of double-counting inherent in the attribution of costs.
- **Implementing and running a strong risk management approach,** which includes introducing a functionally and hierarchically separate risk management function. AIFMs will need to establish a well-documented organisational structure that clearly assigns responsibilities, defines control mechanisms and ensures a good flow of information between all parties involved. Evidence<sup>55</sup>

<sup>53</sup> Alternative Investment Fund Managers Directive: An Overview and Analysis – Viewpoint (2011) Blackrock – May 2011

<sup>54</sup> CP12/32 - Implementation of the Alternative Investment Fund Managers Directive (2012) Financial Services Authority

<sup>55</sup> PWC Global CEO Survey 15 – Asset Management (2011) Price Waterhouse Coopers – this survey is not limited to UK AIFMs

from surveys of CEO's of major asset management firms suggest the majority of them are already considering their approach to manage risk

The Deloitte survey suggested this may require investment for 20% of fund managers. Industry bodies have indicated that fund managers may outsource or delegate this function to some extent. Smaller AIFMs may be unable to recruit additional staff to meet ongoing AIFMD requirements due to the significant cost. While larger AIFMs may well already have separated risk functions, for the smaller AIFMs, this may prove more challenging. Feedback to ESMA on this issue revealed industry concerns that there may need to be some restructuring of senior management in order to separate the reporting lines for portfolio management and risk management<sup>56</sup>. We have therefore applied a range of one-off non-staff costs of an additional £50,000 to reflect possible restructuring costs.

- Funds managers will need to bring in risk management systems and others which are already likely to be largely in place for many managers – including larger managers and those of UCITS funds. Industry feedback indicates that NURS and QIS AIFMs already operating under similar risk arrangements, especially where they manage UCITS funds as well. Therefore, we have assumed costs for NURS and QIS AIFMs will be 0.3 times those for internally managed investment companies.

Hedge fund AIFMs are subject to MiFID, which entails some risk management requirements. However, a survey by Ernst & Young of private equity AIFMs<sup>57</sup> determines that nearly half of them do not have formalised risk management frameworks in place. Therefore, they will incur additional costs in order to ensure the appropriate policies and procedures are in place. We therefore assume that the cost to UCIS AIFMs overall is 1.25x.

- Ensuring all reasonable steps are taken to identify and **manage conflicts of interest** – which includes maintaining organisation and administrative arrangements to identify, prevent, manage and monitor the conflicts. More detail on this is provided in the level 2 delegated regulation.

External AIFMs subject to Mifid have already had to satisfy demanding conflict of interest requirements<sup>58</sup>. However, an FSA thematic review<sup>59</sup> of asset management firms found that some firms had failed to put in place appropriate processes to monitor and manage conflicts of interest, particularly as both the business and compliance units needed to be involved. It may also be particularly difficult for an AIFM to establish a conflict of interest policy that covers the activities of the entities to which it has outsourced. RBC Dexia consider this policy will be particularly onerous on fund managers with a large investor and client base<sup>60</sup>. We have therefore revised the ongoing costs staff and non-staff costs to reflect a bigger potential range and provided a range of one-off staff days.

The figures for operating costs are subject to uncertainty. In addition to the factors given in section A:

- The main industry bodies, AIMA, IMA, BVCA and the AIC play a particularly important role in helping industry understand the implications of these requirements. They organise training sessions, workshops and publish best practise guidelines which ultimately help managers understand and apply the requirements – and keep costs down, particularly for smaller AIFMs which lack a deep pool of in-house support.

<sup>56</sup> ESMA Technical Advice for Implementing Measures (2010) ESMA

<sup>57</sup> The perceived impact of the AIFM Directive on private equity in Europe (2010) Ernst & Young,

<sup>58</sup> IMA Annual Survey (2012) Investment Management Association

<sup>59</sup> Conflicts of interest between asset managers and their customers (2012) financial Services Authority

<sup>60</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

- Separate Compliance, Internal Audit and Risk Management functions may already exist for an AIFM which is part of a large financial services group. Responses to the FSA Discussion Paper from two large financial groups felt that the requirement to establish a separate permanent compliance function would cause an unnecessary duplication of costs if compliance functions already existed at a Group level. There may be some element of intra-group restructuring of such functions in order to meet the directive requirements.
- The FSA is currently introducing a new handbook – and the update of firms' policies will also depend on this, which may for some firms mean having to rewrite their core documentation, while other firms may simply need to re-reference their existing materials.
- Some AIFMs may mitigate ongoing costs through delegating compliance functions to external third parties. We will assume that the costs of delegating compliance functions must be at most equal to establishing the function in-house and therefore not differentiate between firms likely to delegate these functions.

Based upon FSA survey data, industry feedback and the assumptions above, estimated costings under option 1 are:

Operating Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
<b>Compliance</b> NURS (0.3) QIS (x0.3) UCIS (x1) Int Invest Companies (x1.5)	15-30	15-50	1	20-50	15	10	0.5	20
<b>Internal Audit</b> NURS, QIS, UCIS (x0.3) Int Invest Companies (x1)	20-25	1	0.3	20-25	5	10	0.15	25
<b>Electronic record systems</b> NURS, QIS (x0.3) UCIS Int Invest Co (x1)	20-25	10	0.5-1	10-20	5	10	0.25	10
<b>Accounting Policies and Procedures</b> NURS, QIS (x0.5) UCIS (x1) Int Invest Companies (x1.5)	10-15	10	0.5-1	5	10	10	0.25	2
<b>Due Diligence</b> NURS, QIS, UCIS (x0.3) Int Invest Co (x1)	2-5	10	0.4	5-10	2	5	0.2	5

Operating Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
<b>Appointing counterparties</b> UCIS only (x 0.5 as hedge funds only)	5-10	10-20	0.5	1-5	5	5	0.25	1
<b>Fair treatment</b> All x1	10-25	10-20	0.5	1-5	5	5	0.25	1
<b>Risk management</b> NURS, QIS (x0.3) UCIS (x1.25) Int Invest Companies (x1)	25-30	20-30	0.5-1	2-10	5	20	0.5	2
<b>Conflicts of interest</b> All x1	5-30	5	0.5	1-10	5	5	0.25	1

## Option 2

Under option 2, sub-threshold AIFMs would be subject to no formal operating requirements. This would be substantially deregulatory for NURS and QIS funds, and deregulatory for UCIS funds and would represent the status quo for investment companies. Costs are therefore the same as for option 1 but with all sub-threshold AIFM costs £0.

## Option 3

Under option 3, sub-threshold AIFMs would be subject only to current operating requirements. Costs are therefore the same as for option 1 but with sub-threshold AIFMs costs as £0.

## SUMMARY

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
<b>NURS</b>	Above	63-107	222-327	63-107	222-327	63-107	222-327
	Sub	50	129	0	0	0	0
<b>QIS</b>	Above	63-107	222-327	63-107	222-327	63-107	222-327
	Sub	50	129	0	0	0	0
<b>UCIS</b>	Above	128-224	456-687	128-224	456-687	128-224	456-687
	Sub	95	282	0	0	0	0
<b>Int Invest Companies</b>	Above	137-241	479-707	137-241	479-707	137-241	479-707
	Sub	109	298	0	0	0	0

C Delegation requirements

## Option 1

Under option 1, the Government would require all AIFMs to comply with Directive delegation requirements, which will impose consistent regulatory standards for delegates and sub-delegates, as well as requiring reviews and monitoring by AIFMs. AIFMs will have to notify the FSA if they intend to delegate functions to third parties to carry out on their behalf. The AIFM will also have to review the services provided by each delegate on an ongoing basis. As a minimum, requirements on AIFMs will therefore be:

- **Reviewing services provided by each delegate.** Where an AIFM intends to delegate the task of carrying out functions on its behalf, it is required to review the relationships and, where necessary, take legal advice to determine whether new contractual terms are required. It also needs to ensure it is not delegating to the extent that they become a “letter-box entity” without any real substance; and
- **Reporting to the FSA on delegation.** The AIFM will need to notify the FSA of any delegation before the arrangements take effect. This will mean satisfying certain conditions set within the directive including providing an objective reason for the justification of the entire delegation structure, ensuring the delegate has sufficient resources and is properly qualified and where it performs investment management functions – is authorised or registered and subject to supervision by a competent authority.

The delegation provisions have caused extensive discussion and concern in the industry. Respondents to the Deloitte<sup>61</sup> survey listed delegation as one of the most pressing concerns from a cost perspective, with 78% of AIFMs surveyed concerned about it<sup>62</sup>. The concerns have also been frequently raised during the course of consultation and in response to the Government’s consultation paper.

The concerns expressed were that if level 2 implementing measures providing detail on the delegation provisions – in particular a “letterbox entity test” were to set a limit on the tasks that the AIFM can delegate that is significantly more stringent than current practice, firms may need to change business models. As Deloitte also notes, some internally managed funds may need to ‘insource’ functions that are currently delegated.

The measures have now been published and the Government considers there is scope for the Financial Conduct Authority to take a proportion approach to the application of the provisions. The measures do not set a strict limit on the tasks that the AIFM can delegate though firms may need to review their existing business models subject to further guidance from the FCA. It is not yet clear how other Member States will implement the provisions, which will also affect costs to AIFMs.

Costs are therefore considered on the basis that the letterbox entity test won’t in itself lead to wholesale restructuring. However, there may well be significant restructuring as a result of the cumulative effective of the Directive’s other provisions, which will have an impact on the costs of delegation:

- AIFMs as part of large financial groups will need to consider whether the delegation is carried out intra-group or involves independent third parties. This means that the cost of these requirements will vary with the company structure for which the AIFM belongs in. The survey by Deloitte<sup>63</sup> highlighted some of these issues, such as that the AIFM would need to assume responsibility for the investment management functions of an internally managed investment company, which may previously have been allocated to a Board.

<sup>61</sup> The EU’s AIFM Directive (2009) Mats Perrson, OpenEurope – comments on draft AIFMD proposals

<sup>62</sup> Responding to a New Reality (2012) Deloitte

<sup>63</sup> The EU’s AIFM Directive (2009) Mats Perrson, OpenEurope – comments on draft AIFMD proposals

- There may be an element of restructuring by a fund management company in order to have both UCITS and AIF funds managed by the same management company using dual authorisation. A paper<sup>64</sup> by Ernst & Young set out how this might work but it showed there may be a need to delegate to specialist service providers
- The E&Y survey indicated that Private Equity funds do not typically delegate investment management functions so they will be much less affected by the delegation provisions.

The obligation to review services provided by each delegate is similar to that required under UCITS<sup>65</sup> - although discussion with advisors suggests that AIFMD provides permits member states some greater discretion to demand justification of delegation arrangements<sup>66</sup>. Many AIFMs may already be managing UCITS funds and may then choose to ensure their non-UCITS funds are managed in the same way, particularly for NURS and QIS funds. Therefore, the costs incurred in reviewing services for AIFMs managing NURS and QIS AIFs are estimated as a fifth of those managing UCIS AIFs. This cost to internally managed investment companies is estimated as twice that for NURS AIFMs, given the strong likelihood that some or all of their investment management functions will be delegated.

Some aspects of the management of funds are delegated to entities which are local to the underlying securities being traded. The FSA's earlier assessment identified management functions being performed by staff in third country jurisdictions in emerging markets<sup>67</sup>. In order for AIFMs to demonstrate they are taking part in decisions may take up staff days on an ongoing basis. Therefore, the range of ongoing FTE staff has been increased to 0.4 to take account of the range of impacts on staff resourcing.

NURS, QIS, UCIS AIFMs and external managers of investment companies are already required to notify the FSA of delegation so in practice this cost will fall more heavily on internally managed investment companies. We have estimated the cost to internally managed investment companies as being twice that for the other regulatory categories.

The obligation to review services provided by each delegate is similar to that required within UCITS - although discussion with advisors suggests that UCITS<sup>68</sup> provides permits member states some greater discretion to demand justification of delegation arrangements. The impact assessment for UCITS IV<sup>69</sup> highlighted additional one-off costs of up to £20,000 for reporting delegated arrangements which can be considered as a indicative lower-bound for FSA reporting.

The cost to internally managed investment companies remains the same given the strong likelihood that some or all of their investment management functions will be delegated but the level 2 requirements are not expected to result in any additional significant restructuring

Delegation Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
<b>Reviewing services provided by each delegate</b>	40	10-40	0.2-0.4	10	10	10	0.1	5

<sup>64</sup> The Super AIFM – Efficiently Implementing the AIFMD directive (2012) Ernst & Young

<sup>65</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

<sup>66</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

<sup>67</sup> Cost-Benefit Analysis of AIFMD (2009) Charles Rivers Associates/FSA [http://www.fsa.gov.uk/pubs/other/Impact\\_of\\_AIFM\\_Directive.pdf](http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf)

<sup>68</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

<sup>69</sup> Impact Assessment- Transposition of UCITS IV (2011) HM Treasury



NURS (x0.3) QIS (x0.3) UCIS (x1) Int Invest Companies (x1)								
<b>Reporting to FSA</b> NURS, QIS, UCIS (x0.3) Int Invest Companies (x1.5)	20	20-40	0.1-0.2	10	1	20	0.1	5

### Option 2

Under option 2, sub-threshold AIFMs would be subject to no formal delegation requirements. This would be deregulatory for NURS, QIS and UCIS AIFMs and would represent the status quo for investment companies. Costs are therefore as option 1 but with all costs for sub-threshold AIFMs being £0.

### Option 3

Under option 3, sub-threshold UCIS, NURS and QIS AIFMs would be subject only to current delegation requirements, and sub-threshold internally managed investment companies would be subject to no delegation requirements. Costs are therefore as option 1 but with sub-AIFM costs being £0.

### SUMMARY

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
<b>NURS</b>	Above	16-31	13-21	16-31	13-21	16-31	13-21
	Sub	10	6	0	0	0	0
<b>QIS</b>	Above	16-31	13-21	16-31	13-21	16-31	13-21
	Sub	10	6	0	0	0	0
<b>UCIS</b>	Above	36-72	32-59	36-72	32-59	36-72	32-59
	Sub	21	14	0	0	0	0
<b>Int Invest Companies</b>	Above	65-125	52-82	65-125	52-82	65-125	52-82
	Sub	44	24	0	0	0	0

## Liquidity management requirements

### Option 1

Under option 1, all AIFMs would be required to comply with the Directive's liquidity requirements, which set out obligations for managing liquidity risks in all AIFs other than closed-ended non-leveraged funds. The main requirements are:

- **Ensure appropriate systems and processes** are in place to manage liquidity and monitor the risks, ensuring the liquidity profile of the investments of the AIF complies with its underlying obligations. AIFMs will need to ensure their liquidity management policies and procedures are documented and maintained along with escalation procedures. These requirements support the risk management function.
- **Conduct stress tests** to assess liquidity risks of the AIFs – at least once a year. Detailed level 2 regulations specify how the stress tests are to be conducted. There also obligations on FSA to assess the liquidity management systems and procedures.
- **Make disclosures to investors** around the results of the stress tests and ensure redemption policies are clear.

AIFMs will review at least annually liquidity risk profiles of managed AIFs, maintain appropriate liquidity measurement arrangements and conduct stress testing on a periodic basis, not less than once a year. The frequency and rigour of stress testing will depend upon FSA supervisory guidance which will vary in relation to the size and complexity of the AIF and the nature of the assets. AIFMs will need to implement policies and procedures to put into effect tools and arrangements required to manage the liquidity risk of each AIF under management. They will also need to determine whether redemption restrictions are appropriate.

Hedge funds in particular will need sophisticated liquidity management systems on account of the complexity and relatively high leverage they deploy. The Commission's impact assessment<sup>70</sup> pinpointed fund of hedge funds to be particularly vulnerable to redemption requests during the financial crisis, particularly in the event of a counterparty failure. From discussions with industry, many hedge funds have already increased their focus on leverage following the financial crisis – but the requirements will fall particularly heavily on them. By contrast, private equity AIFMs and venture capital AIFMs are unlikely to be severely affected.

Consultation feedback confirmed that AIFMs who also manage funds with UCITS-type rules will already have in place formal liquidity management arrangements which may mitigate one-off costs<sup>71</sup>. In practice, this includes all NURS and QIS AIFMs but also some hedge fund managers. We therefore make a broad assumption that liquidity management costs for hedge fund AIFMs, which fall within the UCIS category, will be twice those for the AIFMs of NURS and QIS AIFs. {I think you should define the multiplier in absolute terms where possible – SFK}

The ongoing costs will vary for the requirement for an AIFM to demonstrate to their competent authorities that appropriate and effective liquidity management policies and procedures are in place. That requires due consideration to be given to the nature of the AIF, including the type of underlying assets and the amount of liquidity risk to which the AIF is exposed, the scale and complexity of the AIF or the complexity of the process to liquidate or sell assets. These matters are specific to the AIF itself. The frequency and rigour of stress testing will depend upon FSA supervisory guidance which will vary in relation to the size

<sup>70</sup> European Commission Impact Assessment L1 (2010) European Commission

<sup>71</sup> A Guide to Planning for AIFMD (2013) the IMS Group

and complexity of the AIF and the nature of the assets. For this reason, an additional AIF level cost has been added to the analysis with ongoing costs of £1,000 to £3,000.

For those AIFMs with funds in multiple jurisdictions, fair treatment of investors plays a material factor. This is an AIF level cost to consider and might require some staffing resource or initial advice on a one-off basis. Our conservative estimate is to suggest additional one-off costs of £1,500 per AIF.

From informal discussions with industry and the FSA, we understand that few investment companies would be caught by Directive liquidity requirements; many investment companies will be unleveraged and closed-ended (closed-ended funds do not accept subscription or redemptions). For leveraged investment companies, we would expect that all would have liquidity policies in place and any adjustments required to come into compliance should not cause significant costs.

Sub-threshold AIFMs are likely to manage fewer and smaller AIFs – and many of them will be unleveraged. Consequently, liquidity management requirements are likely to be considerably less for sub-threshold AIFMs; cost estimates are based loosely on the very limited data in the FSA survey and have been refined to take into account comments and observations through the consultation process. For example, it has been highlighted that the Commission's impact assessment<sup>72</sup> identified that smaller funds were particularly vulnerable in stressed economic conditions as investors displayed a tendency to reallocate funds from smaller funds to larger funds. This places the emphasis on ongoing investor disclosure in sub-threshold AIFMs, and upon review, these costs have increased to £10,000 per year.

Liquidity Management Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000
<b>Systems &amp; Procedures</b> NURS, QIS (x0.5)	20-30	25	0.3-0.5	10-20	3	10	0.2	2
UCIS – x1 Int. Inv Co x0								
<b>Stress testing</b> NURS, QIS (x0.5)	20	5	0.3-0.5	2-5	5	5	0.2	2
UCIS – x1 Int. Inv Co x0								
<b>Disclosure to investors</b> URS, QIS (x0.5)	5-10	10	0.3-0.25	10	5	5	0.1	10
UCIS – x1 Int. Inv Co x0								

Liquidity Management Requirement / Regime (& assumption)	Above-threshold AIFs	Sub-threshold AIFs
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<sup>72</sup> European Commission Impact Assessment L1 (2010) European Commission

assumption)	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000
Reporting to FSA NURS, QIS (x0.1) UCIS x1, Int. Inv Co x0	-	1.5	-	1-3	-	1.5	-	1

### Option 2

Under option 2, sub-threshold AIFMs would be subject to no formal liquidity management requirements. This would be deregulatory for NURS, QIS and UCIS AIFMs and would represent the status quo for investment companies. Costs are therefore as option 1 but with all costs for sub-threshold AIFMs being £0.

### Option 3

Under option 3, sub-threshold AIFMs would be subject only to current liquidity management requirements. We have therefore assumed that costs are therefore as option 1 but with sub-threshold AIFM costs as £0.

### SUMMARY

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
NURS	Above	28-31	48-68	28-31	48-68	28-31	48-68
	Sub	12	26	0	0	0	0
QIS	Above	28-31	43-57	28-31	43-57	28-31	43-57
	Sub	12	26	0	0	0	0
UCIS	Above	60-67	110-145	60-67	110-145	60-67	110-145
	Sub	26	60	0	0	0	0
Int Invest Companies	Above	0	0	0	0	0	0
	Sub	0	0	0	0	0	0

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000
NURS x0.5	Above	467	312-935	467	312-935	467	312-935
	Sub	189	126	0	0	0	0
QIS x0.5	Above	38	25-75	38	25-75	38	25-75

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	Sub	0.75	0.50	0	0	0	0
<b>UCIS x1</b>	Above	720	480-1440	720	480-1440	720	480-1440
	Sub	720	486	0	0	0	0
<b>Int Invest Companies x0.1</b>	Above	0	0	0	0	0	0
	Sub	0	0	0	0	0	0

**Leverage requirements**

The Directive introduces the following leverage requirements:

- **Establishing and maintaining a policy to manage leverage in its AIFs.** The policy will need to be documented and scrutinised. Tools may need to be developed particularly in order to monitor large exposures to a single counterparty. AIFMs will need to implement adjustments to leverage through the borrowing of cash or securities or leverage embedded in derivative positions. AIFMs will need to inform the FSA on the use of leverage in the management of AIFs and leverage policy to be employed;
- **Calculating leverage levels for each AIF.** Leverage levels will have to be calculated in accordance with AIFMD implementing measures and this will need to be set out in the fund documentation. There are two methods that will be used. In general, the commitment method distinguishes between leverage that potentially increases risk and leverage that reduces risk and takes only the former into account in the calculation of the leverage of the fund. The gross method takes both into account, but this method is not commonly used within industry.
- **Setting a maximum leverage level for each AIF,** taking into account a range of factors including the type of AIF, linkages which could expose systemic risk and exposure to a single counterparty. Leverage levels may need to be adjusted in accordance with this maximum leverage levels which may be set by supervisory authorities;
- **Disclosing leverage levels to investors and keeping them updated;** this requirement falls on each AIF. AIFMs will need to ensure that leverage policy is including within the investment strategy to be prepared for investors as part of their due diligence in a fund. Investors will be kept updated on arrangements relating to liquidity management or arising from illiquid holdings, the risk management systems employed and the maximum and current amount of leverage employed by each AIF.
- **Demonstrating to the FSA that the leverage levels set are reasonable** and are being complied with. Funds making use of substantial leverage will be required to disclose aggregate leverage, the form of leverage (cash borrowing, securities borrowing, leverage embedded in derivatives), and the main sources of leverage (lending institutions such as prime brokers, banks etc). AIFMs should monitor their total assets under management on a continuous basis in order to ensure there is not a period where assets (including leverage) are significantly above threshold which may involve the use of the gross methodology to calculate leverage

**Option 1**

Under option 1, all AIFMs would be required to comply with AIFMD's requirements for managing leverage. The following costs are therefore applied:

Leverage Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000
NURS, QIS x0.5 UCIS x1.5 Int. Inv Co x1								
<b>Leverage policy</b>	2	3	0.2-0.4	2.5	2	2	0.1	2.5
<b>Calculating leverage</b>	2-5	15	0.25-0.5	2.5	2	5	0.1	2.5
<b>Setting max leverage</b>	10-20	5	0.5	3	5	5	0.125	3

<b>level</b>								
<b>Disclosure to investors</b>	5	16-30	0.5	3	5	5	0.1	3
<b>Disclosure to FSA</b>	6	5	0.75	3	3	5	0.3	3

Leverage Requirement / Regime (& assumption)	Above-threshold AIF				Sub-threshold AIFs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000	Staff Days	Non-Staff Costs £000	Staff FTE	Non-Staff Costs £000
NURS, QIS x0.5 UCIS x1.5 Int. Inv Co x1								
<b>Leverage policy Fund costs</b>	-	3	-	1.5	-	1	-	1.5

### Option 2

Under option 2, sub-threshold AIFMs would be subject to no formal leverage management requirements. This would be deregulatory for NURS, QIS and UCIS AIFMs and would represent the status quo for investment companies. Costs are therefore as for option 1 but with all sub-threshold AIFM costs being £0.

### Option 3

Under option 3, sub-threshold UCIS AIFMs would be subject only to current leverage management requirements and sub-threshold internally managed investment companies would be subject to no formal leverage requirements.

### Summary

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000
<b>NURS</b>	Large	27-36	96-115	27-36	96-115	27-36	96-115
	Small	14	36	0	0	0	0
<b>QIS</b>	Large	27-36	96-115	27-36	96-115	27-36	96-115
	Small	14	36	0	0	0	0
<b>UCIS</b>	Large	83-112	337-405	83-112	337-405	83-112	337-405
	Small	44	130	0	0	0	0
<b>Int Invest Companies</b>	Large	53-72	186-222	53-72	186-222	53-72	186-222
	Small	28	73	0	0	0	0

### AIF level costs

Regulatory Regime	Size	Option 1	Option 2	Option 3
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		One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000
<b>NURS</b>	Above	£935	£467	£935	£467	£935	£467
	Sub	£126	£189	0	0	0	0
<b>QIS</b>	Above	£75	£37.5	£75	£38	£75	£38
	Sub	£0.5	£0.8	0	0	0	0
<b>UCIS</b>	Above	£2,840	£1,420	£2,840	£1,420	£2,840	£1,420
	Sub	£1,005	£1,508	0	0	0	0
<b>Int Invest Companies</b>	Above	£24	£12	£24	£12	£24	£12
	Sub	£75	£113	0	0	0	0



## Remuneration requirements

### Option 1

Under option 1, all AIFMs would be required to comply with AIFMD's remuneration requirements. At a high level these are broadly similar to existing requirements for firms regulated under MiFID and involve establishing a remuneration policy and following it on an annual basis. In practice, most regulated AIFMs already have some remuneration processes in place which would decrease direct costs

However, there is at present considerable industry concern over more detailed ESMA guidance setting out how the requirements are to be implemented. They potentially restrict the ability of FSA to apply requirements proportionately and extend the requirements through the whole delegation chain. Indirect costs could be much higher, for example the ability to retain staff, if there is ultimately insufficient flexibility.

The FSA is currently considering the extent to which it complies with the ESMA guidelines or explains reasons for its deviation. For this reason, we have estimated some increased direct costs associated with the remuneration provisions but broader indirect costs are noted only qualitatively at this stage.

For remuneration requirements, we do not have FSA survey data, however, the FSA undertook a similar exercise when implementing the European Banking Authority guidelines, to which these requirements are similar, to credit institutions and MiFID investment firms via the UK's Remuneration Code. The FSA received 19 responses from investment firms and the estimated costings below are based upon this survey. The survey confirmed that the main costings would be:

- **Changing the remuneration policy.** Changes may be needed to the ways in which remuneration policies are set within an AIFM, including the need to change the way remuneration is determined on the level of divisions or business units. This may involve changes in firms' processes, systems and controls, additional data collection, reporting and record keeping. For example<sup>73</sup>, the remuneration rules in AIFMD may lead to restrictions on the functioning of performance related schemes in place;
- **Issuing an annual remuneration statement.** New processes may have to be implemented and the additional level of detail required for the statement;
- **Senior management board or committee time.** Members of boards and remuneration committees may have to spend additional time to meet the enhanced regulatory requirements. Firms might also incur additional costs if they seek external advice;
- **Enhanced risk management function.** Risk and compliance functions will be required to take a more active role in remuneration policies; and
- **Adjusting remuneration structures.** The directive proposes to impact upon the fixed and variable remuneration paid by the AIFM to its staff members and other staff relevant to the risk profile of the AIF. It should also be noted that the requirement for the compliance officer to be independently remunerated rather than as a result of the performance of the AIFs managed and this is an additional cost.

The average of costs reported to the survey was £7000 per AIFM one-off costs and £4000 per AIFM ongoing costs. The median cost in both cases was minimal. However, feedback from discussions with advisors and compliance experts during consultation strongly indicated that this was too low

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<sup>73</sup> AIFMD Key Issues for Private Equity and Infrastructure Fund Managers – Clifford Chance – February 2013

- **Identification of key staff** – Feedback from industry indicated to us that one of the likely costs will be taking legal advice upon which staff should be considered as having a material impact upon the risk profile of the AIFs managed and therefore within the scope of the code. Following discussion with industry bodies, this was estimated to cost an additional one-off £15,000 on average in non-staff costs, mainly legal and advisory work;
- **Management of conflict** - some firms have indicated that the level of disclosure to investors was on matters which were immaterial, confidential or proprietary. A point raised to ESMA in its consultation was that those responsible for the financial statements of an AIF will be individuals with a corporate governance duty (if the AIF is a separate legal entity). However, the AIF may not have direct access to the AIFM personnel records or an auditor to verify any information disclosed.
- **Senior management board or committee time.** Members of boards and remuneration committees may have to spend additional time to meet the enhanced regulatory requirements. There is likely to be uncertainty about the balance between fixed and variable pay, deferral periods and clawback clauses. Firms might also incur additional costs if they seek external advice; Through informal consultation, our estimate of this cost<sup>74</sup> will be that a typical remuneration committee meets 2-6 times a year, comprised of 3-6 people for around 2 hours giving total hours of 12 and 72 per year e.g. 0.5-3 staff days.
- **Costs of Disclosure** - Disclosure to investors of aggregate remuneration is not a standard practise for the alternative investments industry. The requirements set out in Article 107 of the level 2 regulations may result in additional costs as they prescribe the content and formal of the disclosure including breakdowns at an AIF level including the carried interest. It also requires the financial and non-financial criteria underpinning the remuneration criteria and incentives which are relevant to the risk profile of the AIF as well as policies in place to avoid or manage conflicts of interest which may arise. Following discussions with advisors to asset management firms, we concluded that this would result in additional £20,000 per year in non-staff costs largely reflecting costs due to legal advice required.
- **Practical Difficulties** – There is not a consensus amongst stakeholders over remuneration, Ernst & Young's survey<sup>75</sup> of private equity AIFMs found 61% has remuneration policies in place and 70% of managers comply with the spirit of the requirements. However, feedback received from legal advisors as suggested that the remuneration requirements as set out in the guidelines will be particularly difficult to implement for partnerships and limited liability partnerships.; Unlike other AIFMs, they have not been subject to the Remuneration code under the Capital Requirements Directive and these requirements are likely to create particular difficulties in terms of reporting requirements, restructuring for tax purposes and. Many of these AIFMs are likely to be within the UCIS category. Therefore, we assume the cost to UCIS AIFMs is 1.5 times that for other AIFMs.
- **Proportionality** - The extent of proportionality in applying the remuneration requirements is a matter for FSA policy. For the purposes of the impact assessment, it would seem sensible to assume that the cost for sub-threshold AIFMs would not be as stringent as above threshold AIFMs. Therefore, we have halved the expected costs for sub-threshold AIFMs.

## Option 2

<sup>74</sup> Is there a negotiation process in UK remuneration Committees? (2012) BG Main and R Belfield, Towers Watson and University of Edinburgh – estimates follow these and checked by stakeholders

<sup>75</sup> The perceived impact of the AIFM Directive on private equity in Europe (2011) Ernst & Young

Under option 2, sub-threshold AIFMs would be subject to no formal remuneration requirements. This would be deregulatory for NURS, QIS and UCIS AIFMs and would represent the status quo for internally managed investment companies. Costs are therefore as option 1 but with all sub-threshold AIFM costs being £0.

### Option 3

Under option 3, additional AIFMD remuneration requirements would not be applied to any sub-threshold AIFMs. Costs are therefore as option 2.

### SUMMARY

Remuneration Requirements / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)
Remuneration Impacts NURS (x1) QIS,(x1) UCIS (x1.5) Int Invest Companies (x1)	0	15-25	1.5-9	20	0	7.5-12.5	1.5	10

### Option 2

Under option 2, sub-threshold AIFMs would be subject to no formal remuneration requirements. This would be deregulatory for NURS, QIS and UCIS AIFMs and would represent the status quo for internally managed investment companies. Costs are therefore as option 1 but with all sub-threshold AIFM costs being £0.

### Option 3

Under option 3, additional AIFMD remuneration requirements would not be applied to any sub-threshold AIFMs. Costs are therefore as option 2.

### SUMMARY

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
NURS	Above	15-25	21-23	15-25	21-23	15-25	21-23
	Sub	8	10	0	0	0	0
QIS	Above	15-25	21-23	15-25	21-23	15-25	21-23
	Sub	8	10	0	0	0	0
UCIS	Above	23-38	31-36	23-38	31-36	23-38	31-36
	Sub	11	16	0	0	0	0
Int Invest	Above	15-25	21-23	15-25	21-23	15-25	21-23

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
<b>Companies</b>	Sub	8	11	0	0	0	0

## **Valuation requirements**

AIFMs are required to establish appropriate and consistent procedures so that a proper and independent valuation of the assets of the AIF can be performed. The AIF's assets are to be valued and calculated at least once a year. There is a behavioural impact here in that investors will have a clearer perception of the valuation methods will help to increase their confidence in the valuation model<sup>76</sup>.

### **Costs upon Fund Managers**

Many fund managers usually carry out the fund valuation themselves but the directive will require separation of this function from portfolio management. This is to avoid conflicts of interest through the manipulation of the portfolio values. The AIFM also needs to disclose the valuation methodology to investors as part of disclosure requirements to investors.

The precise details have been set out in implementing measures which will be applied through FSA rules. The measures set out the rules for the use of models in portfolio valuation, minimum requirements, notably on periodic review and the standards for the valuation process.

Under option 1, all AIFMs would have to comply with AIFMD's requirement which may require appointing an independent valuer and requiring professional guarantees. A survey by Deloitte of UK AIFMs found approximately at least a third may require the services of an external valuer<sup>77</sup>. We would expect an AIFM which is part of a larger financial group to conduct the valuation through the separation of staff from the portfolio manager.

### **Costs upon external valuers**

External valuer will need to assume liability to the AIFM for any loss due its negligence or intentional failure to perform its tasks. There may also be additional costs due to the need to show professional guarantees. These costs have not been independently estimated as they have been assumed to be passed on to the AIFM who in turn will pass on to the AIF or its investors.

### **Costs upon depositaries**

The implementing regulations also set out additional duties on the depository in the conduct of the valuation of units and shares. The depository needs to verify effective procedures are in place for the valuation of assets and also ensure appropriate appointment of an external valuer. The depository also cannot be permitted to perform the value of an AIFs assets if it is also appointed the depository and there is strict separation of the functions. These additional costs for depositaries are assumed to be manageable.

## **Key Assumptions**

1. **UCIS multiplier converted to x2.** Private equity and real estate firms typically have illiquid assets and may not currently rely on external valuers so it is assumed that they may have somewhat higher costs – particularly for smaller funds. The impact assessment conducted by CRA<sup>78</sup> highlighted that private equity and real estate were vulnerable to higher regulatory costs through the valuation requirements. Guidance to industry by PWC<sup>79</sup> Private Equity AIFMs reveals that current industry practice for private equity AIFMs is to carry out the valuation activities themselves but may now face pressure to appoint an additional independent valuer. We have generally taken account of this through separate private equity AIF specific costs.

Likewise, some hedge funds deploying complex strategies may require more effort to appoint independent valuers. This is because assets of a hedge fund may be particularly more costly to be valued by a third party, particularly as the Net Asset Value of the fund is normally calculated

<sup>76</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

<sup>77</sup> Responding to the new reality Alternative Investment Fund Managers Directive Survey (2012) Deloitte

<sup>78</sup> Cost-Benefit Analysis of AIFMD (2009) Charles Rivers Associates/FSA - [http://www.fsa.gov.uk/pubs/other/Impact\\_of\\_AIFM\\_Directive.pdf](http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf)

<sup>79</sup> AIFMD Impact on Private Equity – PWC – Navigating the regulatory maze –PWC Luxembourg – November 2010

by the fund administrator and external valuers may be unwilling to assume liability for complex instruments.

2. **Internally managed investment companies multiplier x1.5.** Independent valuation is also unlikely to be helpful to investment trusts where the market itself determines the price at which investors can buy and sell the fund<sup>80</sup>. These trusts typically trade at a discount to the underlying net asset value of the securities owned. This means it is likely investment companies will need to conduct the valuation themselves, which may entail separation from the portfolio management company and compliance to level 2 standards. The industry body representing investment companies strongly set out the case against establishing strict methodologies for valuation of assets in its response<sup>81</sup> to ESMA. The likely additional costs mean that we also apply a multiplier of 2 to internally managed investment companies.
  - **The cost at a fund manager level** Feedback from industry through discussions for external valuation suggests that the likely costs are most likely to be at the level of fund but there is likely to be economies of scale if many funds are valued by the same external valuer. Therefore, it would be more appropriate to use an AIFM level cost and our initial estimate of £20,000 was considered in line with expectations and also the FSA firm survey.
  - Managers of Fund of Funds vehicles may find it particularly difficult to conduct investments. For example, the FSA<sup>82</sup> permitted Fund of Alternative Investment Funds a longer period in order to obtain a fund valuation.
3. **Revision of one-off costs** Feedback and informal consultations with compliance officers suggest that professional investors increasingly expect to be able to have in arrangements with fund managers and their administrators to obtain the information they require to conduct due diligence on the valuation of assets within an AIF. This includes external valuation if it satisfies the investor. Therefore, the one-off staff costs have been halved from the original estimate.

Following discussions with representations of valuers, the main concern with the implementing measures was that many external valuers normally have liability uncapped only for fraud and misrepresentation, not negligence. Therefore, there is likely to be some further upfront one-off costs for renegotiation of existing contracts in order to assume this liability, which in turn may be driven by the cost of professional indemnity insurance of the external valuer. Therefore, the one-off non-staff costs have been increased from the original estimate

The costs for Option 1 are set out below

Valuation Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
Ensure proper valuation NURS, QIS (x0.5) UCIS (x2) Int Invest Companies	2-5	5-25	0.2-0.5	20-25	1	5	0.2	10

<sup>80</sup> Cost-Benefit Analysis of AIFMD (2009) Charles Rivers Associates/FSA

<sup>81</sup> Submission from AIC on ESMA discussion paper on Article 3 implementing measures (2010) AIC

<sup>82</sup> Fund of Alternative Investment Funds – Including Feedback on CP08/4 (2010) Financial Services Authority

(x1.5)								
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### Option 2

Under option 2, sub-threshold AIFMs would be subject to no formal requirements around relating to valuation. This would be deregulatory for NURS, QIS and UCIS AIFMs and would represent the status quo for investment companies. Costs are therefore as option 1 but with costs for all sub-threshold AIFMs being £0.

### Option 3

Under option 3, sub-threshold NURS, QIS and UCIS AIFMs would be subject only to current valuation requirements, and sub-threshold internally managed investment companies would be subject to no valuation requirements. Costs are therefore as option 1 but with sub-threshold UCIS and internally managed investment companies costs being £0.

### SUMMARY

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
NURS	Above	3-13	18-33	3-13	18-33	3-13	18-33
	Sub	3	13	0	0	0	0
QIS	Above	3-13	18-33	3-13	18-33	3-13	18-33
	Sub	3	13	0	0	0	0
UCIS	Above	7-34	35-75	7-34	35-75	7-34	35-75
	Sub	7	30	0	0	0	0
Int Invest Companies	Above	6-27	18-53	6-27	18-53	6-27	18-53
	Sub	5	21	0	0	0	0

## **Transparency requirements**

AIFMs will have to disclose certain information to investors before they invest in the AIF (or if any material changes have been made). This information is similar to that provided for retail investors including the strategy, use of leverage, identify depositories, auditors and other service providers, preferential treatment to other investors and the identity of the prime broker. The FSA approach will be to set out these requirements within the existing rules.

We have adjusted our figures from the original impact assessment in line with cost-benefit analysis conducted by the Financial Services Authority. The study by Charles Rivers Associates suggested these costs may be very substantive for hedge funds of 0.3bps for one-off costs and 0.1bps for ongoing costs. The Financial Services Authority's cost-benefit analysis<sup>83</sup> suggested that the range of costs may be between £0-£60,000 on a one-off basis and £0-£36,000 on an ongoing basis.

### **Option 1**

#### **Costs to Fund Managers**

##### **One-off costs**

Other requirements for disclosure to investors such as preferential treatment for some investors and the use of side-letter agreements, may go beyond prevailing norms. One example of this is the requirement to disclose any discharge of liability by a depository or change in liability in the funds. This may entail additional costs as some AIFMs may opt to address this through the production of a supplement to the standard prospectus. Firms may incur additional costs in benchmarking their disclosures<sup>84</sup> with respect to AIFMD to ensure they keep within industry norms

Within the transitional year, there may be transitional costs which would largely fall under the compliance function of ensuring existing disclosures are in line with the directive requirements. The main one-off cost for AIFMs would be to undertake a gap analysis to consider what further work is required to be done. An Ernst & Young<sup>85</sup> survey of private equity AIFMs suggested three quarters of AIFMs are likely to conduct this work ahead of obtaining authorisation, which is reflective of industry as a whole. *We have therefore introduced modest one-off staff days cost of 2 days to reflect staff time with half this for sub-threshold AIFMs*

##### **Ongoing Costs**

The provision of an annual report and audited financial statements are likely to be standard requirements for industry and may already be demanded by some investors. On the other hand, some fund managers may need additional training in order to understand the requirements *We have therefore introduced a range in this section with a much lower bound of £5,000 in additional one-off non-staff costs*

The preparation of information for investors may be relatively more intensive for open-ended funds as closed-ended funds usually do not have new investors after the subscription period has passed. Just under a fifth of respondents of private equity respondents<sup>86</sup> felt that transparency requirements including disclosing conflicts of interests would be the largest impact on their business. *We have therefore suggested that this requirement may need 0.2 FTE to 0.5 FTE to be employed on an ongoing basis*

##### **Costs to the AIF**

AIFs will now need to publish an audited annual report which requires specific information to be provided in addition to the usual financial data. The annual report of the AIF must also summarise the material changes. This includes details about remuneration in relation to the fund, exposures and controlling stakes the AIF holds in companies, Just under a fifth of private equity AIFMs surveyed by Ernst & Young

<sup>83</sup> Implementation of the Alternative Investment Fund Managers Directive – Annex 1 (2012) Financial Services Authority

<sup>84</sup> The IMS Group's Guide to Planning for AIFMD (2013) Jonathan Wilson, IMA Group

<sup>85</sup> The perceived impact of the AIFM Directive on private equity in Europe (2011) Ernst & Young

<sup>86</sup> The perceived impact of the AIFM Directive on private equity in Europe (2010) Ernst & Young



felt that the amount of information supplied to investors as part of improved governance arrangements to be potentially problematic.

The implementing regulations have also provided further requirements on the form of content of material disclosed to investors including the content of the annual report, accounting standards and rules. These are in line with established business practises although the FSA will set out further details on what is required in due course. It is expected that these will incur significant one-off costs *and so we have introduced a range of one-off AIF-level costs from £3,000-£4,000.*

The information which needs to be made available to investors should be in accordance with the constitution of the AIF. This may mean that the AIFM needs to make information available at least upon request, but possibly through other more costly ways such as a website or proactively and *so we have introduced a range of ongoing costs of £2,500*

## Key Assumptions

### 1. Introduction of AIFM level One-off Staff Costs

Some AIFMs may find this onerous and unfamiliar<sup>87</sup>, particularly as they will be subject to FSA supervision for the first time There are likely to be some staff costs incurred. We have based staff day costs upon an impact assessment<sup>88</sup> on the Transparency Directive which suggested compliance and managerial staff required additional time to familiarise themselves with the new requirements.

### 2. Multiplier of x1.25 for UCIS AIFMs

The directive also requires an AIFM to insert provisions within key documents for existing AIFs. This may include provisions such as the disclosure of the AIFs assets, the ability to provide preferential treatment, the ability of the AIFs depository to transfer liability to a sub-custodian. It may be the case that changes such as these to a funds documents will require the approval of investors and notice periods before a change can be effected. This is likely to be particularly onerous for AIFMs of UCIS funds. *We have therefore introduced a multiplier of x1.25 to reflect higher non-staff costs.*

Transparency Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
<b>Disclosure to investors</b> NURS, QIS (x0.5) UCIS x1.25 Int Inv Co x1	2-5	5-25	0.2-0.5	20-25	1	5	0.2	10

<sup>87</sup> A New Path for Alternative Investments – A Guide to AIFMD, unregulated and alternative UCITS funds (2013) RBC Dexia

<sup>88</sup> EU Transparency Directive 2004 Implementation Impact Assessment (2004) [HM Treasury](#)

Regulatory Regime	Size	AIF level costs	
		One-off Costs	Ongoing Costs
		£	£
Disclosure to Investors	Large	3-4	2-2.5
	Small	3	1

### Option 2

Under options 2 costs would be as option 1 but for all sub-threshold AIFMs and AIFs managed but sub-threshold AIFMs, **one-off** costs would be £0

Under option 3, transparency requirements would not be applied for subthreshold AIFMs. The extent to which FSA would introduce a regime with lower regulatory burdens would depend upon the final level 2 measures, but potentially reporting requirements could be less frequent or use a more simple form. Costs are therefore as option 2.

### Summary

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
NURS	Large	3-13	18-33	3-13	18-33	3-13	18-33
	Small	3	13	0	0	0	0
QIS	Large	3-13	18-33	3-13	18-33	3-13	18-33
	Small	3	13	0	0	0	0
UCIS	Large	7-34	35-75	7-34	35-75	7-34	35-75
	Small	7	30	0	0	0	0
Int Invest Companies	Large	6-27	18-53	6-27	18-53	6-27	18-53
	Small	5	21	0	0	0	0

*Aggregated Costs at a Fund Level*

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000	One off costs £000	Ongoing Costs £000
<b>NURS</b>	Above	935-1246	623-779	935-1246	623-779	935-1246	623-779
	Sub	378	126	0	0	0	0
<b>QIS</b>	Above	75-100	50-63	75-100	50-63	75-100	50-63
	Sub	2	1	0	0	0	0
<b>UCIS</b>	Above	2366-3155	1578-1972	2366-3155	1578-1972	2366-3155	1578-1972
	Sub	2513	838	0	0	0	0
<b>Int Invest Companies</b>	Above	24-32	620-775	24-32	620-775	24-32	620-775
	Sub	225	75	0	0	0	0

## **FSA Reporting Costs**

Increased transparency towards regulators was advocated by the de Larosiere Group<sup>89</sup> as necessary in order to improve macro-prudential oversight. The more onerous reporting obligations imposed on the largest and more complex AIFMs is intended to ensure that key variables such as leverage, risk, concentrations, liquidity and size of positions are disclosed to the FSA in order to allow European regulators to reach a clear and timely view on existence and scale of systemic vulnerabilities

The final cost of the reporting requirements is likely to be shaped to some extent by ESMA guidelines on the reporting obligations. Final advice by ESMA<sup>90</sup> implicitly acknowledged the costs would be disproportionate for smaller AIFMs as they pose less systemic risk – therefore there was a reduced frequency for smaller AIFMs

### **Option 1**

#### **Costs on Fund Managers**

##### **One-off Costs**

AIFMs will also be required to report to the FSA regularly on each AIF under their management. Information which is likely to be required includes trading, investment strategy, geographical and sectoral exposures, markets, principal exposures and other information for each fund. These obligations will apply on an ongoing basis even for AIFMs which are registered with the FSA.

Reporting obligations will result in one-off costs for the AIFM. Managers will need to start identifying what data is required, how it will be sourced and how its accuracy will be validated<sup>91</sup>. The AIFM will need to invest in IT and the appropriate tools in order to generate this information automatically. The AIFM will then need to provide this information to the FSA on a regular basis, and this has already been felt within industry to be a challenging timetable<sup>92</sup>.

Estimated transparency costs are likely to be quite substantive. Following consultation and informal discussions with service providers to investment funds, a revised approach has been taken in order to address these based on costs which had been in place for US fund managers upon the introduction of Form PF reporting.

The reporting costs may be mitigated somewhat through the cost being part of outsourcing arrangements with fund administrators and other service providers. A survey by Deloitte<sup>93</sup> considered that just under half of AIFMs which would require external support, would be doing so in order to fulfil their reporting requirements. *For this reason, we have amended one-off non-staff costs via a range of £30,000-£70,000 and reduced one-off staff days to 10. The lower bound has been taken for sub-threshold AIFMs.*

##### **Ongoing Costs**

AIFMs will be required to report to the FSA regularly on each AIF under their management. In practise, the collection of this information may be outsourced to the fund administrator<sup>94</sup>. A survey by Deloitte<sup>95</sup> found that 66% of AIFMs were concerned by the additional reporting requirements and 94% said it would

<sup>89</sup> Report of the de Larosiere Group (2009) European Commission – This report led to the establishment of the European Systemic Risk Board

<sup>90</sup> AIFMD – ESMA's technical advice on transparency and leverage (2012) Nabarro Financial Regulations

<sup>91</sup> The IMS Group's Guide to Planning for AIFMD (2013) IMS Group

<sup>92</sup> Alternative Investment Funds: Challenging Months Ahead (2013) Ernst & Young

<sup>93</sup> This point flows from Responding to the new reality – Alternative Investment Fund Managers Directive (2012) Deloitte where 53% of survey respondents said they would do this with examples such as indirect transaction costs and further risk data

<sup>94</sup> The IMS Group's Guide to Planning for AIFMD (2013) IMS Group

<sup>95</sup> This point flows from Responding to the new reality – Alternative Investment Fund Managers Directive (2012) Deloitte where 53% of survey respondents said they would do this with examples such as indirect transaction costs and further risk data

result in additional costs. *Ongoing staff FTE has remained unchanged to reflect the likelihood that non-staff costs may increase to reflect necessary investment in IT rather than increase manpower.*

Feedback to the consultation is that estimates based on FSA survey data are too low because reporting requirements are more stringent – and more complex – than it was believed at the time of the survey. At the same time, the Commission’s level 2 impact assessment<sup>96</sup> suggested that additional costs from increased reporting frequencies would be subject to diminishing returns to scale – AIFMs with more frequent reporting requirements would be submitting the same information and simply validating it to competent authorities. *This suggests that the additional ongoing staff FTE could be higher than 1.5 for above threshold and a range has been applied for non-staff costs to £30,000-£60,000 and ongoing sub-threshold FTE staff now have increased non-staff costs of £25,000, half the lower bound of the range.*

The information which will be subject to reporting by the AIFM to the Financial Services Authority will depend upon the number of AIFs managed and their complexity, particularly if they are leveraged. The Level 2 impact assessment<sup>97</sup> acknowledged that costs would rise with trading frequency and the complexity of items within the reporting template. Views at an industry seminar<sup>98</sup> suggested this will require significant oversight of the collection of reporting information, which will require hiring additional resource – however, this included ongoing staff costs for liquidity and leverage disclosure rules. *For this reason, we suggest ongoing staff costs are in a range of 0.6 FTE – 1 FTE, where the lower bound reflects potential costs from other AIFMD reporting requirements. Sub-threshold AIFMs are at 0.5 FTE.*

## **Key Assumptions**

### **1. UCIS Multiplier Treatment**

Some UCIS AIFMs already report similar data to the FSA as part of the hedge fund survey though disclosure requirements are more extensive and frequent under the Directive. However, this may in practice be offset by the increased complexity of some hedge funds. On the other hand, there is evidence<sup>99</sup> which suggests that operational resources will need to increase in order to cope with the additional reporting obligations for AIFMs of private equity AIFs. Given the uncertainty on impact, we have not made assumptions about the relative cost for UCIS AIFMs relative to other regulatory categories.

### **2. Subthreshold AIFMs**

During our consultation, we also spoke with sub-threshold NURS AIFMs and concluded that the reporting requirements would also mean additional costs although this was largely driven by the leverage requirements. However, there was concern about having to bring in new systems in order to fulfil reporting requirements. Our view is that these valid concerns have been taken account of within the existing changes to the reporting requirement costs.

<sup>96</sup> AIFMD Impact Assessment L2 (2012) European Commission

<sup>97</sup> AIFMD Impact Assessment L2 (2012) European Commission

<sup>98</sup> Reporting Under AIFMD and its US Counterparts (2012) Dechert Seminar – March 2012

<sup>99</sup> See AIFMD – Impact on Private Equity – Navigating the Regulatory Maze (2010) [PWC](#)

Transparency Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
<b>FSA Reporting Costs</b> NURS x1 QIS x1 UCIS x1 Int. Managed Inv Co x1	10	30-70	0.6-1	30-60	10	30	0.5	25

### Option 2 & Option 3

Under option 2, costs would be as option 1 but for all above-threshold AIFMs and AIFs managed. All sub-threshold AIFMs would be subject to a registration-only regime. However, these obligations will apply on an ongoing basis even for AIFMs which are registered with the FSA.

*Under options 2 & 3, These costs have been estimated as at £25k-£50k taking account of complexity and legal advisory costs. The reporting costs for de minimis AIFMs is more limited than above threshold requirements so we have applied the sub-threshold AIFM ongoing costs but at a factor of approximately half. One-off costs have been disapplied*

The extent to which FSA would introduce a regime with lower regulatory burdens depends upon ESMA guidelines following the publication of the level 2 requirements, but potentially reporting requirements could be less frequent or use a more simple form. Costs are therefore as option 1 but with costs for sub-threshold UCIS and internally managed investment companies being £0. Costs for sub-threshold NURS and QIS AIFMs – and NURS and QIS AIFs managed by sub-threshold AIFMs - are assumed to be half those of option 1.

## SUMMARY - PER AIFM

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)	One-off cost per AIFM (£000)	Ongoing cost per AIFM (£000)
NURS	Large	34-74	79-141	34-74	79-141	34-74	79-141
	Small	34	66-141	0	33	0	33
QIS	Large	34-74	79-141	34-74	79-141	34-74	79-141
	Small	34	66	0	33	0	33
UCIS	Large	34-74	90-160	34-74	90-160	34-74	90-160
	Small	34	75	0	38	0	38
Int Non-CIS AIF	Large	34-74	79-141	34-74	79-141	34-74	79-141
	Small	34	66	0	33	0	33

## Depository requirements

### Option 1

AIFMs are required to appoint depositaries which will:

- Ensure cash flows are properly monitored;
- Provide oversight of the management of the assets; and
- Where this is possible, hold those assets in custody.

Many AIFMs already have depositaries but the Directive expands their liabilities and obligations, and extends their use to new types of fund. NURS and QIS AIFMs, together with some UCIS AIFMs (excluding private equity, venture capital and most property funds) are already required to appoint depositaries for at least custodian services. However, AIFMD places further obligations on depositaries; most significantly there will now be near-strict liability for the restitution of assets throughout depositaries' entire sub-custody chain; depositaries typically delegate to others where the AIFM wishes to invest in jurisdictions in which the depositary does not have a branch or subsidiary. Verification and oversight responsibilities are also strengthened. By contrast, internally managed investment companies will be required to appoint depositaries for the first time.

Private equity, venture capital UCIS AIFMs and property AIFMs would need to appoint depositaries for the first time, however AIFM prescribes a special set of requirements for these on the basis that the majority of the requirements will be oversight as the majority of their assets – unlisted companies, properties – cannot be held in custody. Depositary services are typically provided by banks but the Government is taking an advantage of a Directive derogation to permit non-bank custodians to provide depositary services to this group of AIFMs. In practice, specialist fund administrators are likely to take up this offer and provide competition to bank depositaries which also have specialist units providing services to private equity clients. Feedback from the British Venture Capital Association confirms industry interest in using these new depositaries.

Depositary costs are particularly challenging to estimate; feedback from depositaries suggested factors they will depend upon include:

- Commercial drivers; the relative market power of depositaries versus AIFMs, and the extent to which depositaries regard the Directive as an opportunity to cross-sell other services;
- AIFMs with AIFs based outside the UK may use depositaries in other jurisdictions where competitive pressures and costs may be different;
- The exact nature of the monitoring and verification requirements – there remained some uncertainty following publication of the Delegated Regulation and the industry awaited further FSA guidance at the time this Impact Assessment was updated; and
- Further depositary consideration of the extensive liability requirements set out in the Commission's level 2 Regulation. These include liabilities where the depositaries have delegated to others outside their control, such as unaffiliated third party sub-custodians.
- It is possible there may be some loss of competition in the market for prime brokers. Some hedge funds, depending upon their strategy and exposure, may find their choice of prime broker



particularly limited by depositaries' willingness to accept liability for assets deposited with the broker<sup>100</sup>.

Ernst & Young surveyed depositaries and a number of hedge funds on behalf of the Alternative Investment Managers Association (AIMA) to determine current costs and to seek to estimate costs of implementing AIFMD for full depositary services (i.e. including custody). Current fees were estimated at 20-35 bps; estimates of additional costs – mainly as a result of capital or insurance needed to meet liability requirements ranged from 10-25 bps to 100 – 150bps. The range reflected uncertainty at the time.

The E&Y survey itself emphasises the difficulty in calculating costs and notes that depositaries may have erred on the side of caution. This is quite likely as the incentive on depositaries was to provide the most pessimistic forecast. Moreover, the upper end of costs is likely to only apply to the most exotic and risky AIF strategies and to those managers deemed risky by depositaries.

By contrast, aggregated current fees negotiated by a large fund manager (with therefore strong purchasing power) we spoke to ranged from 0.18 – 1.00 bps for custody services in developed jurisdictions and additional 1.75 – 2.00 bps (in the UK and Ireland) for the provision of safekeeping and general oversight functions. Examples of their current custody costs in more exotic locations ranged from 25 – 50 bps though they stressed these represented only a small part of portfolios, even for frontier market funds. They noted that many of their euro-denominated securities would be cleared through Euroclear and they wouldn't expect the custody element of depositary costs for these to change at all.

For this data and wider informal feedback from fund managers, in this interim impact assessment, we will therefore assume an average increase in costs towards the lower end of the E&Y estimates – i.e. between 5-20 bps.

Industry respondents confirmed that depositary costs for private equity / venture capital AIFMs would be lower; we have estimated 5-10 bps. This is broadly consistent with one consultation respondent which estimated depositary costs as £50-100k for a sub-threshold AIF.

Given the considerable uncertainty over depositary fees, it would be misleading to attempt to quantify the variation in costs for sub-threshold AIFMs, although anecdotally they are less commercially attractive to depositaries and so may well have costs proportionate to assets under management that are slightly higher than for larger AIFMs. We have assumed costs for subthreshold AIFMs are midway between the high and low estimates for above threshold AIFMs.

We do not have sufficient data to estimate the one-off cost of appointing a depositary and / or negotiating new terms. This is likely to be significant for internally managed investment companies and private equity / venture capital AIFMs which are appointing a depositary for the first time.

<b>Depositary Requirement / Regime (&amp; assumption)</b>	<b>Above-threshold AIFMs Ongoing cost (bp)</b>	<b>Sub-threshold AIFMs Ongoing cost (bp)</b>
<b>Depositary cost</b> NURS, QIS, UCIS, ext Invest Companies (x1)	5-20 (5 – 10 for Private Equity & Venture Capital)	12.5 (7.5 for Private Equity & Venture Capital)
Int Invest Companies	10-40	25

<sup>100</sup> Custodian Banks balk at AIFMD rules (2013) FT.com - <http://www.ft.com/cms/s/0/12bdc778-37c5-11e2-a97e-00144feabdc0.html>

## One-off Costs to AIFMs

AIFMs will have to appoint a depository and / or negotiate new terms – including more stringent cash-flow monitoring, depository liability and potential discharge, escalation procedures and details of circumstances under which assets may be rehypothecated.

Consultation responses have provided the data to estimate one-off costs. This is likely to be particularly significant for internally managed investment companies and UCIS AIFMs, where we have estimated the costs as double those for NURS and QIS AIFMs. Similarly, prime broker and sub-custodian contracts will need to also be reviewed. These costs would all be covered within non-staff costs for the drafting of a depository manual (50 staff days and £25,000 in non-staff costs) and associated non-staff costs which may be legal costs (£50k in non-staff costs). We have no reason to conclude costs for sub-threshold AIFMs may be lower.

Depository Requirement / Regime (& assumption)	Above-threshold AIFMs				Sub-threshold AIFMs			
	One-off Costs		Ongoing Costs		One-off Costs		Ongoing Costs	
	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)	Staff Days	Non-Staff Costs (£000)	Staff FTE	Non-Staff Costs (£000)
Appointment of a depository NURS/QIS (x1) UCIS (x2) Int. Inv companies (x 2)	50	75	See above	See above	17	25	See above	See above

## Additional costs to the depositories

The requirements of the Directive and its implementing measures will result in additional costs as a result of acting as a depository of an AIF. Those costs have proved to be very difficult to determine in themselves and to some extent, have been assumed to be passed on to AIFs and their AIFMs through additional fees. However, the extent to which fees can be passed on will depend upon the competitiveness of the sector and the demand from AIFs. It is plausible to assume that depositories will absorb some of the broader costs of the requirements themselves initially, and this section adds one-off costs to depositories.

For simplicity we have assumed that where depositories act for UK AIFMs, costs are passed on to the AIFMs. However, where they will also act for non-UK EEA AIFMs passporting AIFs into the UK.

Following discussion with a number of depositories and legal advisors, it was agreed appropriate to use the modelling for similar arrangements in the Treasury's impact assessment for the UCITS IV<sup>101</sup> directive. In this impact assessment, it was assumed that the cost of introducing measures to ensure the oversight and verification required under UCITS IV would cost depositories an additional £100,000. Given AIFMD's requirements are more stringent, feedback was that this should be doubled to £200,000 and applied it to the 7 existing depositories to obtain a cost of £1.4m.

AIFMD also imposes similar obligations on depositories to ensure information is shared between the depository and third parties of the AIFM such as prime brokers, counterparties, fund administrators and

<sup>101</sup> Annex E- Impact Assessment – Transposition of UCITS IV (2011), [HM Treasury](#)

others. Following discussion with some depositories, this is expected to result in the need to devise appropriate procedures and establish model agreements for information sharing, and appropriate indemnities. The cost of this obligation to depositories in the UCITS IV impact assessment was £50,000 per depository and this is also applied to the 7 firms.

<b>Depository Requirement / Regime (&amp; assumption)</b>	<b>Minimum One-off residual Cost per depository (£000)</b>	<b>Total Cost for depositories (£000)</b>
<b>Risk Management oversight</b>	<b>200</b>	<b>1400</b>
<b>Reporting Procedures</b>	<b>50</b>	<b>350</b>
<b>Total</b>		<b>1750</b>

Depositories are also expected to incur certain costs for existing UK AIFs on an ongoing basis which cannot necessarily be directly passed on to the AIFM. Depositories are liable for losses to the fund but the extent of the liability will depend upon how the FCA transpose the level 2 requirements into their rules. However, the requirements upon depositories is expected to include ongoing staff training and monitoring for cash monitoring, arrangements for ongoing verification with funds and other similar responsibilities. Discussions with some depositories identified these costs may be absorbed by the depository but they may be significant depending to some extent on the extent of depository liability in place. We have attributed an average cost of £1,500 per AIF under each option to take account of this recognising that this cost will ultimately be variable depending upon the AIFM and the AIFs managed.

<b>Ongoing Admin costs</b>	<b>Option 1</b>	<b>£3,522</b>
<b>£1,500 per AIF</b>	<b>Option 2</b>	<b>£2,025</b>
<b>Total</b>	<b>Option 3</b>	<b>£2,025</b>

These estimates are particularly crude as they do not take account of the inevitable complexity and uncertainty as well as potential economies of scale, as depositories conduct this business on a regular basis for UK AIFMs. They exclude other costs such as establishing agreements with sub-custodians.

### **Option 2**

Option 2 would involve removing depository requirements for sub-threshold NURS and QIS AIFMs, together with sub-threshold UCIS AIFMs (excluding private equity, venture capital and most property funds) are already required to appoint depositories for the purpose of oversight and custody. No new depository requirements would be placed on other types of sub-threshold AIFM.

Estimates of costs are as Option 1 but with costs for all sub-threshold AIFMs being zero.

### **Option 3**

Maintenance of a regime as close as possible to the status quo would not require internally managed investment companies and Private Equity UCIS AIFMs to have a depository. NURS and QIS AIFMs, together with non-Private Equity UCIS AIFMs would maintain their existing depository regimes with fewer requirements than AIFMD and lower liability on depositories.

However, the Government took into account that this would lead to a two-tier system of investor protection in NURS and QIS, which retail investors (in the case of NURS) would be unlikely to comprehend.

Estimates of costs are therefore as for option 1 but with costs for sub-threshold UCIS and internally managed investment companies being zero.

## SUMMARY

Aggregated estimated depositary costs for each regulatory regime are therefore:

Regulatory Regime	Size	Option 1 Ongoing cost (£m)	Option 2 Ongoing cost (£m)	Option 3 Ongoing cost (£m)
<b>NURS</b>	Above	45-181	45-181	45-181
	Sub	3	0	0
<b>QIS</b>	Above	2-8	2-8	2-8
	Sub	0.1	0	0.0
<b>UCIS</b>	Above	221-798	221-798	221-798
	Sub	27	0	0
<b>Int Invest Companies</b>	Above	13-40	13-40	13-40
	Sub	8	0	0

## **Private Equity Provisions**

The Directive places requirements on the AIFMs of private equity AIFs in order to promote transparency to workers and prevent asset stripping. These are:

- An AIFM must notify the FSA where the AIF it manages acquires control of a non-listed EU company or where shareholdings reach, exceed or fall below certain thresholds (10%, 20%, 30%, 50% and 75%);
- When the AIF acquires control, it must provide selected information to the FSA, company and to the employees. The information includes details around its acquisition, including financing arrangements, and its intentions towards the company. Where possible, the company's annual report – and where not possible – the AIF's annual report has to contain updated information on an ongoing basis; and
- There are restriction on the capital the AIF may withdraw for 24 months following acquisition, in order to prevent asset stripping.

A survey<sup>102</sup> by Ernst & Young of AIFMs of European private equity AIFMs found that the disclosure requirements upon acquiring control were unlikely to result in significant extra costs to the AIFM beyond those already incurred in implementing AIFMD. However, feedback received from firms suggest the impact is likely to be felt in practise at the level of the AIF instead. The main costs are:

**Disclosure of information.** Consultation feedback suggested that some AIFs may need to take legal advice in order to determine what information may be disclosed and the appropriate method for doing so. For example there may be risks to some investors that may be considered. Briefings by Clifford Chance<sup>103</sup> suggest this may be an area of uncertainty for AIFMs particularly if there is an intention to close target premises or make workers redundant which may mean taking legal advice, or include contractual undertakings from managers of portfolio companies.

Our assessment is that the disclosure of information costs are likely to be similar in nature (though smaller) to those incurred in the duties undertaken by an AIFM's permanent compliance function as the AIFM needs to ensure the AIF does not undertake actions which would contravene the directive requirements. We have assumed given the much more limited scope, that costs will be 10% of those incurred by the compliance function. The costs have been applied on a one-off and ongoing basis at the level of the fund.

**Asset stripping restrictions.** The asset stripping restrictions are expected<sup>104</sup> to require more time in considering legal details of decisions, including the drafting of documentation. It will also impact upon pre-contractual negotiations and due diligence by investors in an AIF ahead of undertaking an acquisition in order to minimise economic losses to investors from the restrictions. We have suggested the average additional cost of the asset stripping measures is likely to be similar in practise to costs faced by AIFMs in addressing conflicts of interest, but applied at the level of the AIF as the obligations place duties upon the AIFM to ensure no material detriment is incurred by the company or its employees which are assets of the AIF.

<sup>102</sup> The perceived impact of the AIFM Directive on Private Equity in Europe (2011) Ernst & Young

<sup>103</sup> This point follows from one raised in AIFMD Key Issues for Private Equity and Infrastructure Fund Managers – Clifford Chance – February 2013

<sup>104</sup> This point follows from one raised in AIFMD Key Issues for Private Equity and Infrastructure Fund Managers – Clifford Chance – February 2013

**Valuation Costs.** In the chapter on valuation, we indicated that private equity AIFMs were likely to experience additional costs as a result of the valuation requirements. This is because they are likely to need to appoint staff which are hierarchically independent in order to conduct an independent valuation of complex or difficult to value assets, which are likely to be companies. This work in itself is also likely to require additional legal costs as well as resource on an ongoing basis to conduct this work after a suitably qualified person is appointed. We have assumed it would require an additional 10% of the cost of valuation on a one-off and ongoing basis at a fund level.

	Above threshold AIFs		Sub-threshold AIFs	
	One-off costs £000	Ongoing Costs £000	One-off costs £000	Ongoing Costs £000
<b>Private Equity provisions</b>				
<b>Disclosure to investors</b>	2-6	12-15	2	7
<b>Asset Stripping Provisions compliance</b>	7-18	51-60	7	26
<b>Valuation Costs</b>	4-6	6-11	2	5

In addition to direct costs, there are some broader costs:

- **Competition** - Private equity AIFs are not the only types of funds which are likely to acquire a controlling interest in significant unlisted companies in Europe. Other funds which are not in scope of the directive, such as Sovereign Wealth Funds, will end up with a slight competitive advantage as they are free of these restrictions. It should be noted that alternatives to private equity AIFs will also not be subject to supervision or the other regulatory costs of AIFMD
- **Practicalities** – The actual cost will fall upon the AIFM but is likely to be shared if the AIFM is co-operating with other AIFMs managing AIFs that jointly acquire control of a listed company. However, some of these other investors may not necessarily be AIFMs, for example, they could be management teams working alongside private equity funds.
- **Cost on businesses** – A non-listed company acquired by an AIF must also inform its employees or their representatives about the acquisition of control and relevant information provided by the AIFM. The disclosure obligations are similar to that required under the Takeover directive which was implemented in the Companies Act 2006 which suggested<sup>105</sup> the impact upon listed companies was between £400-£800 per company. However, it is difficult to quantify this independently without estimating the number of significant EU businesses likely to be acquired by UK AIFMs of private equity AIFs.
- **Deadweight Investment Costs** - Just under half of AIFMs surveyed by Ernst & Young<sup>106</sup> felt the limitations on asset stripping would make investment opportunities less attractive.

### Option 1

Under option 1, the private equity requirements would apply to all AIFMs with private equity AIFs. Therefore, they would be subject to the additional costs of the restrictions.

### Option 2

Under option 2, the sub-threshold AIFMs of private equity AIFs would be subject to the de minimis regime and therefore would not be subject to the additional directive requirements unless they chose to opt-in to the directive.

### Option 3

<sup>105</sup> Companies Act 2006 – Regulatory Impact Assessment (2007) BIS

<sup>106</sup> The perceived impact of the AIFM Directive on Private Equity in Europe (2011) Ernst & Young

Under option 3, above threshold AIFM would be subject to the directive requirements and therefore all AIFs managed by such funds would be caught. Option 3 simply imposes the status quo on sub-threshold AIFMs.

### Summary

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One off cost per AIF (000s)	Ongoing cost per AIF (000s)	One off cost per AIF (000s)	Ongoing cost per AIF (000s)	One off cost per AIF (000s)	Ongoing cost per AIF (000s)
Private Equity	Above	14-31	69-86	14-31	69-86	14-31	69-86
	Sub	£11	£38	£0	£0	£0	£0

### Aggregated Costs

Regulatory Regime	Size	Option 1		Option 2		Option 3	
		One off cost £m	Ongoing cost £m	One off cost £m	Ongoing cost £m	One off cost £m	Ongoing cost £m
Private Equity	Above	4-10	22-27	4-10	22-27	4-10	22-27
	Sub	3	11	0	0	0	0