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Regulation and Fund Domiciles

RBC Investor & Treasury Services Special Edition 2019

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Private Equity International

Private Debt Investor

KEYNOTE INTERVIEW

A quiet evolution

The depositary's role is changing as firms and service providers adapt to shifting regulation and the need to stay ahead of technological developments, says RBC's Priya Nair

Once a small corner of the fund administration space, depositary services have grown substantially over recent years as they became essential to any alternative asset manager seeking capital from European investors under AIFMD rules. And, as private capital firms become increasingly complex organizations, with more diverse investment strategies and larger pools of different types of investor, depositary services have had to keep up with and, in many instances stay ahead of, the pace of change.

PEI Media spoke to Priya Nair, managing director and global head of product management for private capital services at RBC Investor & Treasury Services, to find out how the depositary role is changing and how providers can help transform the way private capital firms operate.

Q How has the depositary's role evolved over the past few years?

Priya Nair: One of the biggest changes we have seen was clearly the implementation of AIFMD, which requires managers regulated under the directive to appoint a depositary to provide an oversight and safekeeping function. Yet this has not just driven business toward depositary service providers, it has prompted much more thought and consideration among fund managers and third-party service providers around the extent and type of outsourcing that can be achieved. For example, US managers that have traditionally leveraged Cayman and/or Delaware may not have outsourced much, if any, but may have had to review this operating model given the need for a depositary if they are seeking European capital. That leads to discussions around what services beyond those related to depositary functions might make sense, particularly given the greater need for more sophisticated technologies for reporting and overall running of an efficient firm.

Q How are depositaries responding to this shift?

PN: Private markets have really come of age in the past few years. Fund managers now have scale, increasingly broad investment mandates, wider pools of investors, more structures and, overall, far greater complexity in their businesses than before.

For depositaries, that means we need to have a broader understanding of areas such as ownership structures, investor expectations, how structures interact with each other and appropriate reporting needs. We really have to understand individual client strategies. This is not just about looking to deliver the right products and services to them but, as a depositary, taking on the liabilities – we have to develop appropriate risk-adjusted frameworks to serve our clients and, of course, to understand what we as a business are taking on.

Q What are you seeing in private equity in particular?

PN: We are seeing a lot of complexity. For example, North American managers increasingly create parallel structures in Europe and entities are being formed to allow for a range of different investment types. So, in addition to depositary services, they are considering outsourcing beyond fund administration and accounting, and increasingly looking at middle office functions.

As they come under pressure for more detailed reporting, they are looking for solutions that work across the fund life cycle. So, beyond the need to meet compliance requirements for institutional investors, GPs are turning to us to provide help with areas such as investor servicing and management, cash management and valuation/reporting – the plumbing of these funds.

Q And what are you are seeing in private real estate?

PN: Private equity real estate increasingly encompasses a diverse set of investment strategies and that has a bearing on what we as the depositary need to understand. As the asset class diversifies across a range of investment types and geographies, so too does the regulatory requirements, which increases the complexity of remaining compliant. The depositary needs to be able to cater to these variances, which can be subtle but still different.

Real estate fund managers are also exploring additional ways of outsourcing their middle as well as back office in order to increase their overall efficiency while combining cost and time savings. Within this industry, the underlying trend is to stay focused on the core business cycle across three key phases: fundraising, investment and divestment. As they come under increasing pressure for more detailed reporting, they are looking for solutions that work across the fund life cycle. So, in addition to the need to meet compliance requirements for institutional investors, managers are turning to us to provide help with areas such as investor servicing and management, cash management and valuation/reporting – the plumbing of these funds.

Q And what about private debt?

PN: In private debt, a lot of the complexity in our work comes from the fact that funds' investment mandates can vary significantly. There's clearly a lot more activity in the illiquid private debt space as funds fill the void left by the banks, which face regulatory constraints on their lending, yet many also invest in more liquid strategies. We have to ensure we are monitoring these investment types. This requires a high degree of expertize on the part of the depositary because clearly there is a large difference in profile between liquid and illiquid debt strategies.

"As firms increasingly want to focus on core activities, we see a role for us building long-term partnerships where we have multiple touchpoints with clients"

PRIYA NAIR
RBC Investor & Treasury Services

Q What are managers looking for in a depositary in today's market?

PN: Clearly, managers need a depositary that understands their business – not just the asset class, but one that understands the firm itself and, importantly, the investment strategy. They are also looking for clarity on what a depositary's risk-adjusted framework approach is. Given that firms are facing a squeeze on margins and fees, managers are looking for a depositary that can provide the most appropriate service at a suitable price.

As a consequence, many are no longer just looking for a provider but more of a partner that understands their needs and proactively looks to support their business growth by proposing robust value-add solutions.

Pricing naturally reflects the depositary's risk and liability assessment of a client and so if we have a deep understanding of what a fund's investment strategy is, we can arrive at smarter pricing while taking account of the funds' life cycle. We are therefore seeing much greater variation in pricing, which is fine-tuned and bespoke to individual clients.

Managers are also focusing much more on ex-ante investment controls – they want more flexibility from depositaries to allow them to invest without delays. Depositaries need to be mindful of how they can facilitate controls to reflect how quickly a client wants to enter the market.

Q How is the debate around full depositary services versus depositary-lite shaping up?

PN: As the interpretation of the rules under AIFMD varies, as too does the comfort depositors are taking on when using these services, often it can be an iterative process with the client. Regulators have taken a different view on this, too. The original interpretation of the rules was that a depositary would offer full-fledged services

Digital journey: depositaries can help professionalize data management

across different jurisdictions – given that European institutional investors all have similar needs from a depositary – alongside fund administration duties. Yet there are other interpretations which suggest that, as long as you do enough to comply with the regulations, you can have a slimmed-down version of depositary services as a standalone; that is, without fund administration. It is still unclear where we will end up.

There is another school of thought that suggests the depositary role will continue to be needed, but it will evolve to include administration services and there is scope for greater value-add to clients as depositaries can help professionalize reporting and data management. I think what we will see is the emergence of multiple models for the different requirements of clients according to their investor base and investment strategies, whether funds are offering co-investment and so on. The role of the depositary will evolve to reflect the variation in requirements and this will be enabled by technological developments.

Q You mention technology – how are private real estate firms deploying this?

PN: Firms are starting to evolve their platforms to deal with increasing complexity. They are beginning to apply similar operational principles to their own organizations as they apply to their investments. Fundamentally, they are looking at how to optimize their organizations through outsourcing and gain access to new technologies to benefit from digitization and the automation of manual processes.

In addition, there is a lot more discussion and implementation of technologies such as blockchain in private equity real estate. They are looking at this as a way of disintermediating multiple parties in the process and creating a single source of truth. That is quite an exciting development.

Q And how are private equity firms deploying technology?

PN: Private equity firms are looking to apply similar operational principles in their own organisations to those in their portfolio companies. They will outsource areas where they know they can optimise operations through the use of digitisation and automation for more manual tasks.

While private equity is a people business and LPs are paying for the discretion exercised by a fund manager, there is much that firms can do to optimise their processes so they can focus on the areas where they add value. For that, they need a strong data management strategy – they need to think about how they are storing data, who has access, and how it is dealt with across jurisdictions. They need to ask themselves what they want their data story to be and what the architecture around it needs to be. We're having a lot of discussions with firms about how they can redesign their client journey through reporting and analysis by providing understandable data that enables investors to continue to invest, including areas such as information on how they source deals.

Q As a relative newcomer to the market – certainly in Europe and Asia – how are private debt funds approaching outsourcing more broadly?

PN: While we are seeing a shift towards the back and middle office being outsourced in areas such as private equity, the story is slightly different with private debt. Some newer managers are opting for platforms that enable them to launch without building out whole teams. Yet for others, the fact that private debt funds are generally smaller means that outsourcing may not yet be cost-effective.

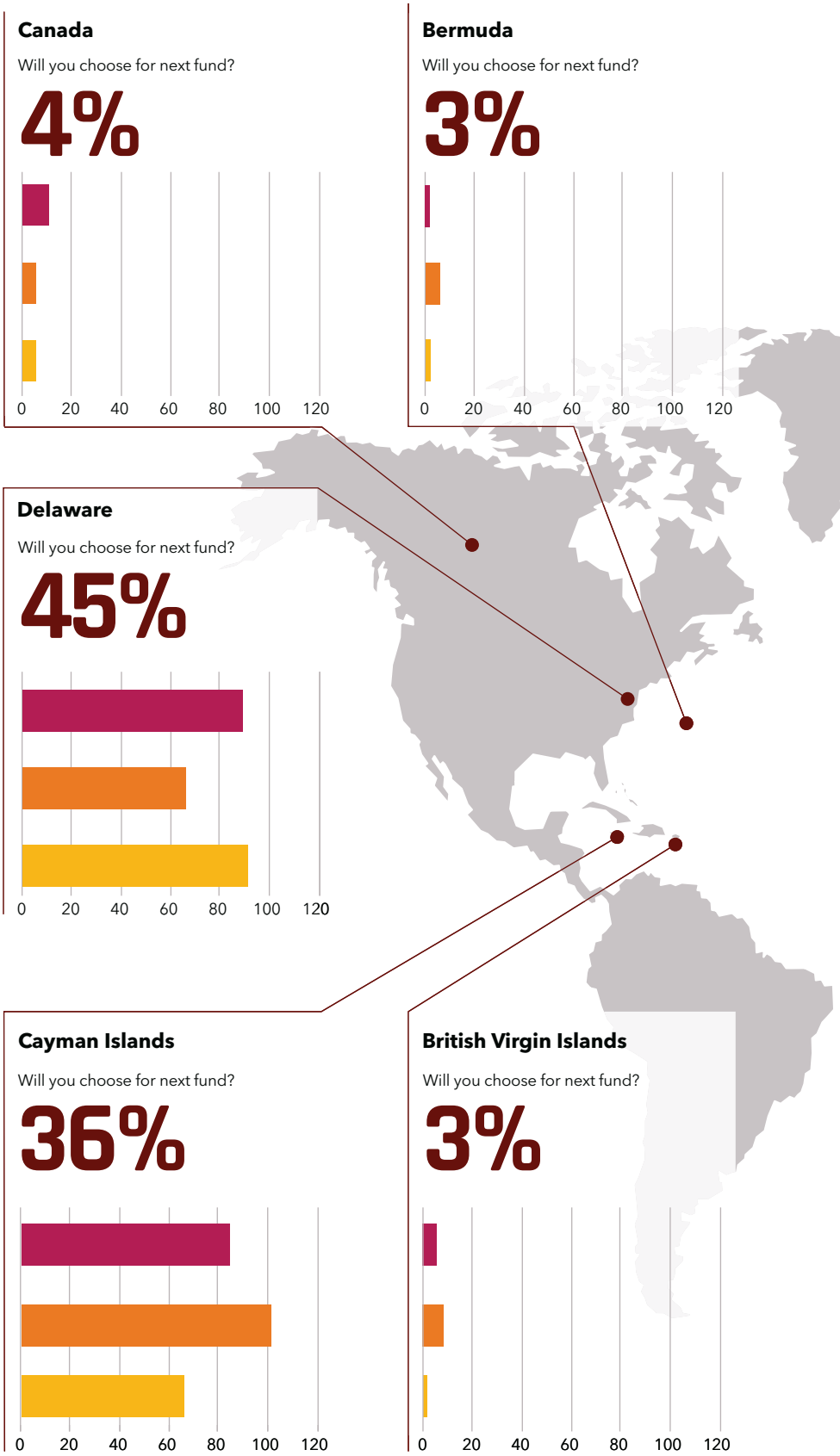
For those that are outsourcing, they are looking for partners with enough knowledge, experience and understanding to help with the plumbing and that can help them create transparency across the liquidity spectrum and deal with the characteristics of where they invest. While in private equity the nature of investments tends to be reasonably similar, in private debt a bilateral SME loan is very different from a large senior leveraged loan that has been syndicated. Debt is a more complex instrument than equity because of where it sits in the capital structure. Private debt managers are having to think about how they provide appropriate reporting to investors that provides transparency across the whole portfolio. It's currently challenging for them to find that perfect solution.

Q What future developments do you see for depositary services?

PN: As firms increasingly want to focus on core activities, we see a role for us building long-term partnerships where we have multiple touchpoints with clients. As depositaries, we are already collecting and storing large amounts of data on behalf of our clients – we can be creative here. If we can evolve to be a partner to private funds, offering comfort that we are storing their data appropriately, we can start to offer more analytical services to help with a firm's core functions. We can be part of their digital journey and the extent of the arrangement could be quite deep – there are already some large private market players partnering with law firms so that they become almost an extension of their own organization, and there may be scope for this for depositary and fund administration service providers too. ■

Regime ratings

Delaware, the Cayman Islands and Luxembourg are the top jurisdictions for private fund managers, according to our survey, with all three domiciles ranking highly in terms of regulatory framework, tax framework and business conditions



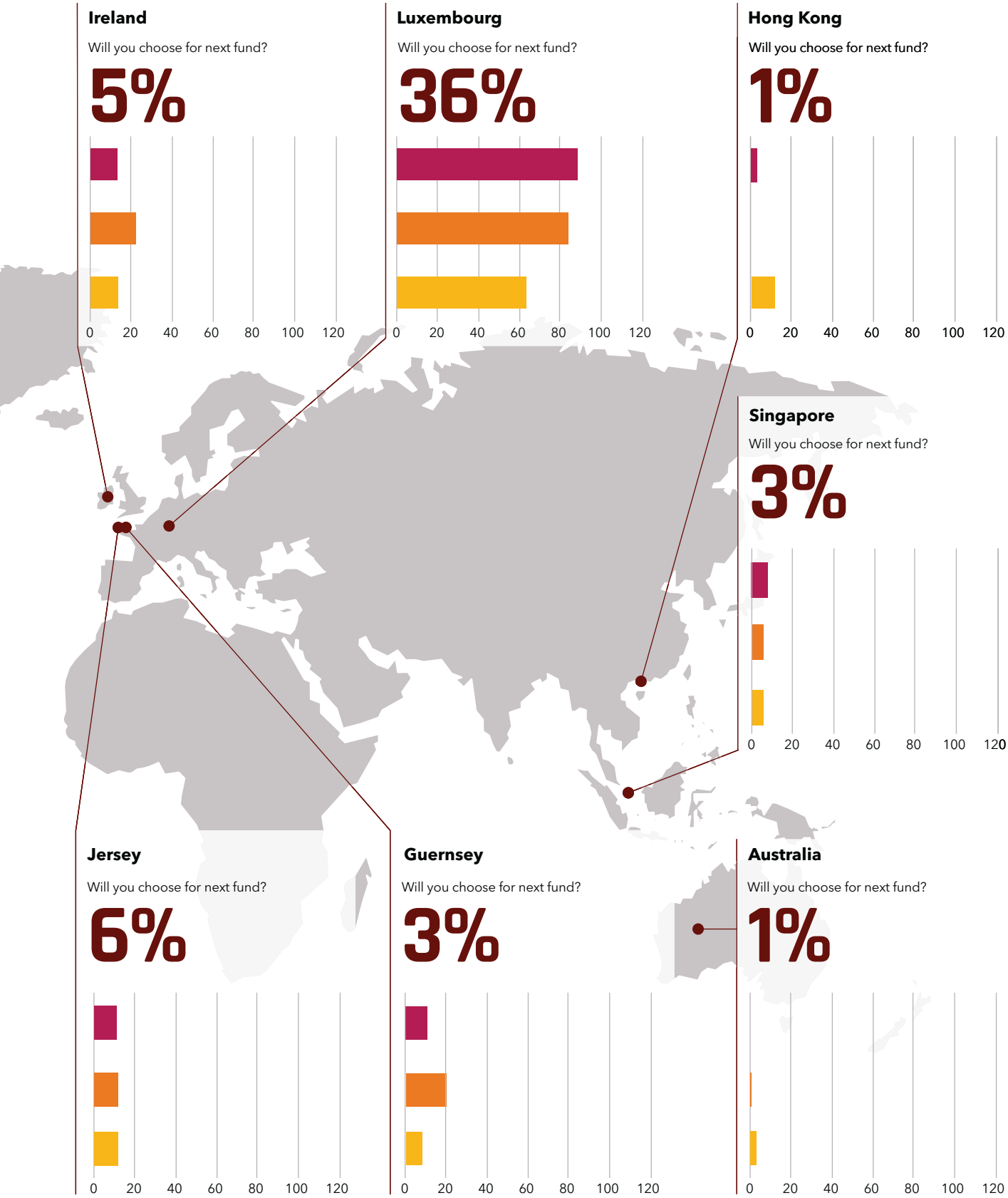
The jurisdictions were rated based on the following questions. Where respondents were asked to give three answers, the first answer was given three points, the second two points and the third one point.

Next fund
Which of the following domiciles will you choose for your next private fund launch/reallocation? (Select all that apply)

Regulatory framework
Which of the following domiciles offers the optimal regulatory framework in 2019? (Select the top three)

Tax framework
Which of the following domiciles offers the optimal tax framework in 2019? (Select the top three)

Business conditions
Which of the following domiciles offers the optimal conditions for doing business in 2019, such as expertize? (Select the top three)


Ireland
Will you choose for next fund?
5%
0 20 40 60 80 100 120
Luxembourg
Will you choose for next fund?
36%
0 20 40 60 80 100 120
Hong Kong
Will you choose for next fund?
1%
0 20 40 60 80 100 120
Singapore
Will you choose for next fund?
3%
0 20 40 60 80 100 120
Jersey
Will you choose for next fund?
6%
0 20 40 60 80 100 120
Guernsey
Will you choose for next fund?
3%
0 20 40 60 80 100 120
Australia
Will you choose for next fund?
1%
0 20 40 60 80 100 120

The search for stability in a shifting environment

In an increasingly complex investment market, managers are sticking with traditional fund domiciles and opting to outsource more of their operational functions, survey findings reveal

Private fund managers are increasingly opting to domicile funds in Luxembourg, our exclusive survey carried out in conjunction with RBC Investor & Treasury Services reveals. The top three jurisdictions remain consistent with a survey we conducted last year – in which we polled private equity real estate fund managers – with Delaware, Luxembourg and the Cayman Islands well ahead of rivals. However, this year's survey, which includes the views of private equity real estate, private equity and private debt funds managers, suggests the popularity of Luxembourg has risen over the past year to match the Cayman Islands.

When asked which domicile private fund managers would choose for their next private fund launch, Delaware emerges as a clear leader, with 45 percent of respondents choosing this as a jurisdiction, 36 percent opting for Luxembourg, with the same proportion selecting Cayman. All three are highly rated for their optimal conditions for doing business and for their regulatory and tax framework.

This is quite a turnaround in a relatively short space of time. "If you rolled back a few years, the UK and Channel Islands would have appeared among the top jurisdictions for private funds," says Leith Moghli, partner at Reed Smith. "While they are still relevant, Luxembourg's development as a fund center has largely been to their detriment. It has been a key beneficiary of substance requirements under BEPS, the Paradise Papers and Brexit, while also introducing the SCSp, which has made structuring much more straightforward."

Luxembourg has increasingly become a hub for AIFMD compliance among those seeking capital from European investors. The launch of the SCSp, or special limited partnership, in 2013 – a limited partnership agreement that is effectively a copy and paste of Delaware and UK limited partnership documents – was the start of Luxembourg's rise.

But developments since have boosted its popularity, including the UK's vote to leave the European Union, the implementation of BEPS and increasing LP concerns about using offshore structures following the Panama Papers and Paradise Papers leaks, and the marketing passport available for AIFMD-compliant private funds.

A large part of Luxembourg's growing allure is down to the parallel structures being established by US managers. Proskauer partner Edward Lee points out: "In our own analysis of European funds, we've seen a big shift in Luxembourg's favor over the past 12 months, in particular among UK funds, a move that is clearly Brexit-related. However, we are also seeing a number of US managers establish parallel structures in Luxembourg, where they either establish their own AIFM or use third-party AIFM service providers and delegate back to the US."

"Luxembourg is a relatively easy place for US fund managers to do business," adds Stephen Meli, partner at Proskauer. "In key ways it's becoming the Delaware of Europe for US managers. The entities Luxembourg offers are similar to those available in Delaware and the Cayman Islands for fund structures and the documentation is similar, even down to the way the documents read. There's also a network effect, where every additional US manager that establishes a parallel vehicle there helps attract others."

Investors are also gaining comfort that Luxembourg's regulatory regime and its requirement for depositary services under AIFMD offer them added protection, a trend also noted by Nicolas Fermaud, head of the New York office at Elvinger Hoss.

"Where firms have had parallel structures for two to three years, we have noticed a disproportionate increase of the commitments collected through the Luxembourg structure," he says.

"In part, managers are raising more capital from European investors, but it's also because investors globally are becoming increasingly comfortable with Luxembourg as a jurisdiction. For firms that equalize costs across their platforms, the Luxembourg set-up with its depositary and regulatory regime is clearly more attractive for many investors."

Private fund managers are also eyeing fairly significant growth in assets under management. Over a quarter see an increase of 10-20 percent growth in the next year and over half expect over 20 percent in the coming decade.

This increase will come from a wider variety of investors from a broader range of geographies. The majority of respondents (88 percent) expect to increase the proportion of investors from Asia (excluding China), 81 percent anticipate a rise in North American investors and 53 percent predict that capital from Central and South American investors will make up a higher proportion of their AUM.

Tapping new PE demand

With 74 percent of private equity funds in our survey expecting an increase in AUM of at least 20 percent over the next decade, including more than two-thirds expecting to achieve this within half that time, investor relations and fundraising teams in this part of the alternative assets space are set for a busy time.

There is clearly demand from institutional investors as fund sizes have increasingly crept up over the years since the 2007-08 crisis.

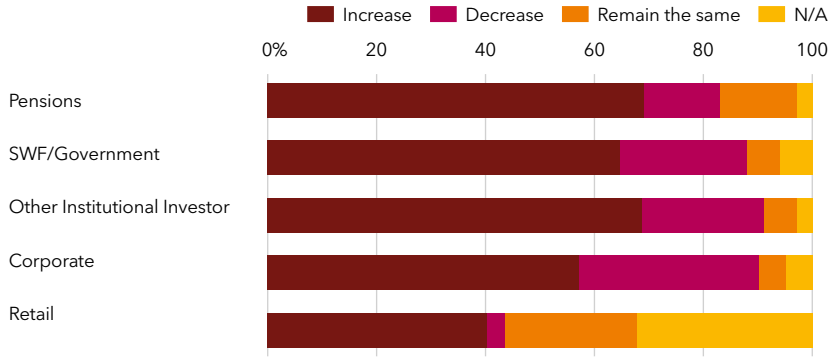
Yet private equity funds also have their eye on the retail market, our survey shows. Nearly half of respondents expect to increase retail investors in their investor base mix, including 19 percent predicting a large increase.

There has been some movement in this space, according to Reed Smith's Moghli. "Over the past 12 months, I've seen the launch of a handful of fully fledged private equity operating platforms aimed at retail investors that provide fully automated administration processes," he says.

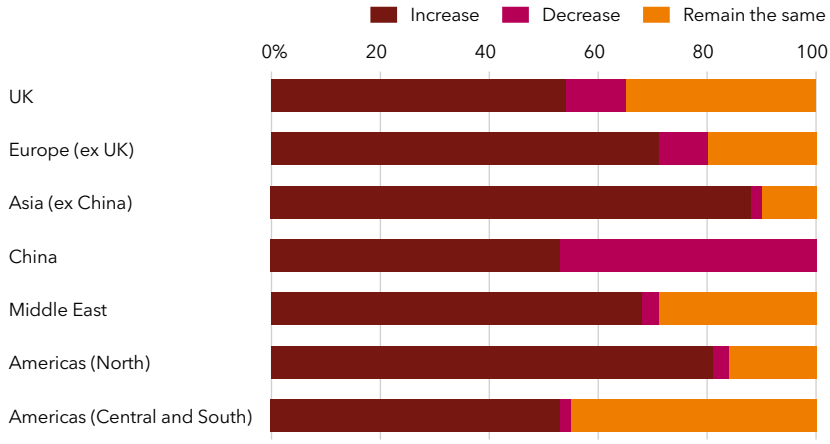
"However, they aren't targeting the average person on the street – they generally require minimum income levels of around £100,000 and assume a certain amount of investment sophistication."

Yet major developments look some way off, especially in Europe where regulations are currently not well tailored to the needs of private equity.

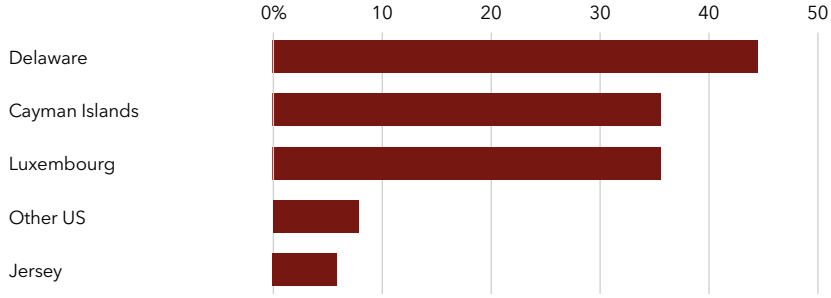
How do you expect your investor base to change in the next five years, by type of investor?



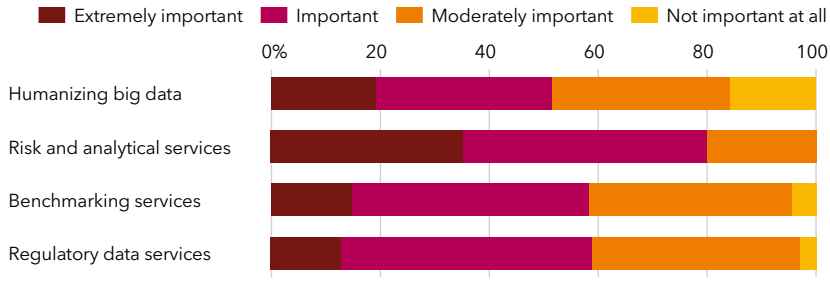
How do you expect your investor base to change, in the next five years, by location of investor?



Which domicile will you choose for your next private fund launch/reallocation?



How important are the following data management strategies to your firm?



All this adds up to increased complexity when it comes to managing private fund businesses. Many respondents are looking to outsource parts of their operations: 51 percent of respondents are seeking to outsource at least half of the fund administration part of their business and a third of respondents want to outsource at least 50 percent of their technology function, with 28 percent and 20 percent saying the same about legal and regulatory services, respectively. "Outsourcing

among fund managers is clearly being driven by a desire to optimize their operations and focus on what they do best," says Holz. "It's also a way for them to manage certain risks, such as regulatory risk, given that it's challenging to keep up with regulations across the different markets they are operating in."

Big data, automation and artificial intelligence rank top among respondents for their potential to disrupt private capital investment in the next three years, yet over a quarter are not planning on implementing these technologies, and many report having little expertise in this area.

Less disruptive technologies could however help private funds streamline their processes without the need for high levels of investment. Priya Nair, managing director and global head of product management for private capital services at RBC, says: "Smart contracts, for example, can help create base templates where there are a lot of similarities, such as liability frameworks, without the need to have a large element of involvement from lawyers. Regtech has a lot of potential for helping firms monitor regulatory developments globally and ensuring firms can stay ahead of the game – it could streamline passporting, for example, and be applied to AML and KYC compliance."

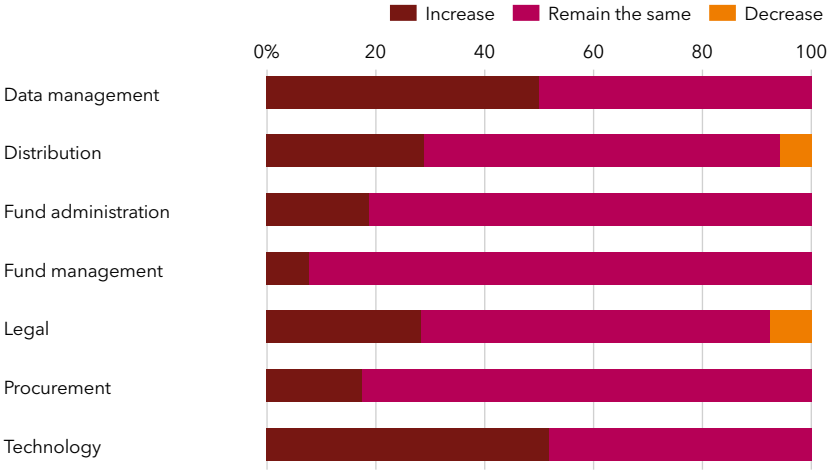
For those that invest in deploying technologies like big data, the prize could be access to better dealflow. "Firms are looking at how they digitize their internal processes at a time when there is a lot of dry powder in the private markets space," says Nair. "They need to differentiate themselves around how they originate and how they create value in their portfolio."

And being able to differentiate from the competition is uppermost in respondents' minds. While the biggest barrier they perceive to achieving their objectives in 2019 is the economic environment (mentioned by 72 percent), competition is second for 42 percent of respondents. ■

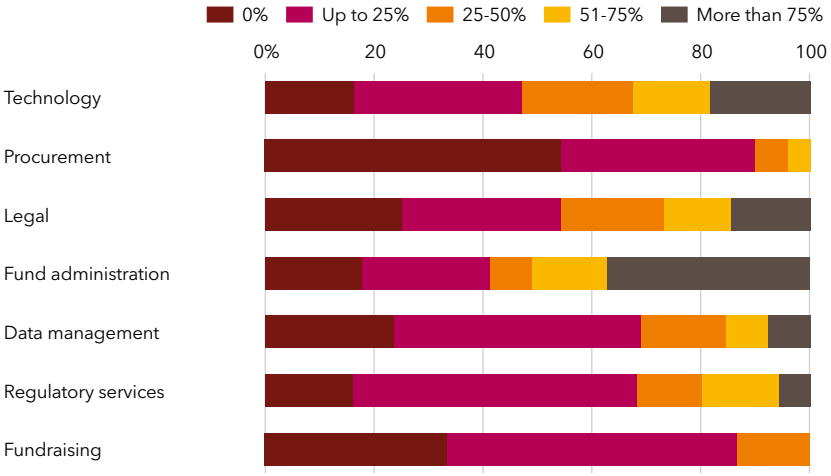
Methodology

PEI Media surveyed 82 private fund managers about a range of fund domicile and regulatory issues. Answers were given on a strictly anonymous basis and the results aggregated.

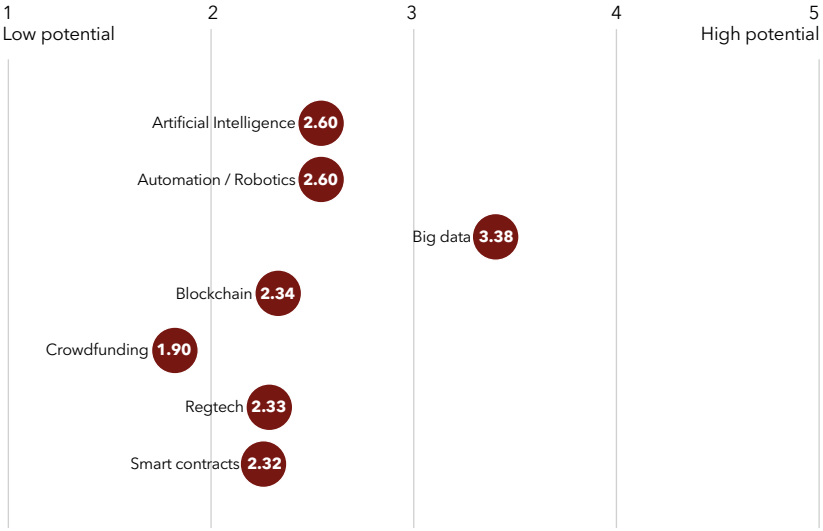
How will you approach outsourcing of the following areas over the next 12 months?



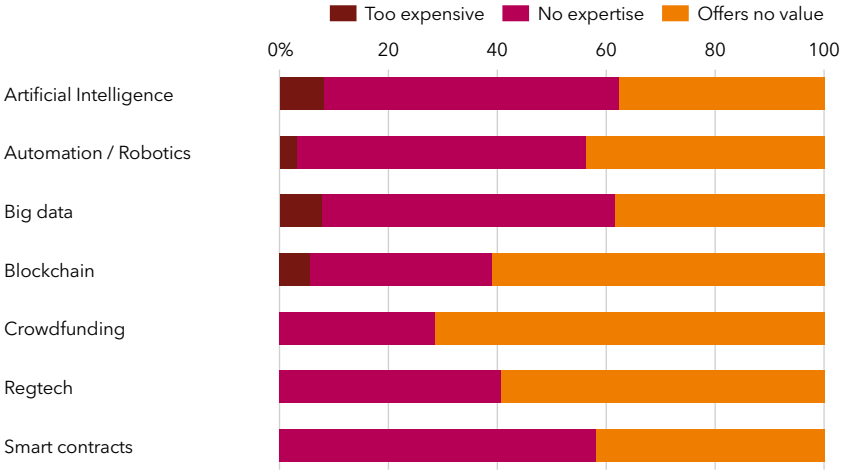
What is your target outsourcing level for the following areas?



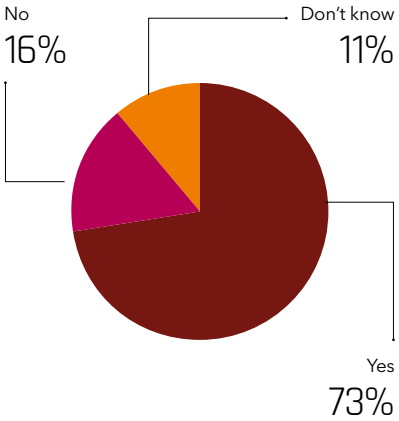
What is the potential for the following to disrupt the private capital investment and service space in the next three years?



If your organization is not planning to implement any of the following, what is the biggest reason?



Do you intend to make use of any capital call facilities over the next 12 months?

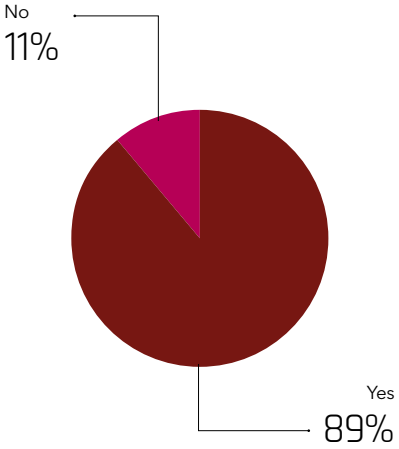


AUM rise may drive need to outsource

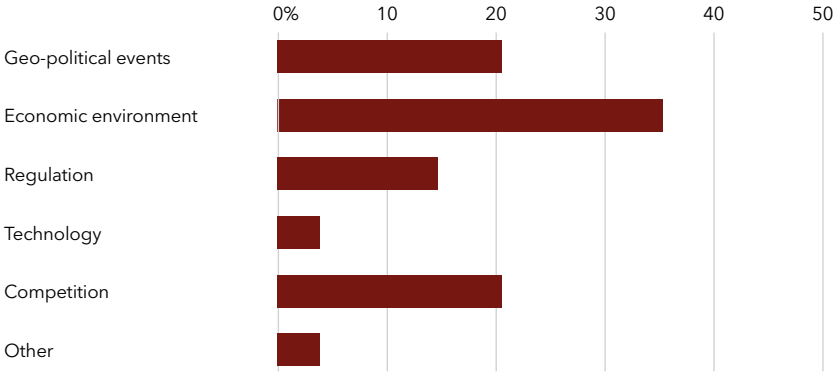
Private real estate managers had the most aggressive expectations for AUM growth among the three main types of private fund, the survey found. A quarter of private real estate funds in the sample anticipate an increase of 20 percent or more within the next year, significantly higher than private equity at 15 percent. To achieve this, private real estate funds will seek more capital from sovereign wealth funds, with 79 percent of respondents expecting an increase from this source compared with 72 percent expecting an increase from pension funds and 50 percent from retail investors. While a similar proportion of private equity funds are expecting an increase in retail investors, this looks rather more achievable for private real estate funds, given the prevalence of REIT structures in the US.

Yet the survey also suggests that private real estate funds may be somewhat behind their private debt and private equity cousins when it comes to outsourcing. Currently, just 27 percent of private real estate fund managers outsource their fund administration and just 13 percent expect to move up to a quarter of this function out of house over the coming 12 months. Private real estate fund managers also manage a far greater proportion of their data management and distribution in-house than either private debt or private equity. However, they have ambitious targets over the longer term, with most functions other than procurement and fundraising largely set for outsourcing.

Do you use a capital call facility to bridge between an investment and the capital contributions?



What will be the main barriers to meeting your objectives in 2019?



Do you use fund financing loans?