Alternative solutions to the SMIC dilemma

A Prescient Fund Services (Ireland) Whitepaper

PRESCIENT
FUND SERVICES (IRELAND)

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FUND MANAGEMENT SUBSTANCE AND THE ECONOMICS OF OUTSOURCING

What is the challenge?

European Union (EU) regulators, including the Central Bank of Ireland (CBI), have identified shortcomings following a review of the structures and operating models of the EU regulated funds industry. These are primarily centred around governance and the fact that many funds may have insufficient substance in terms of oversight of the activities of the fund and investment manager.

At the same time, there are ever-increasing pressures on costs, not only from regulators expecting UCITS, AIFMD and MiFID investment managers to act in the best interests of investors and provide value for money, but also due to the huge rise in popularity of passive investing via low fee ETFs to the detriment of actively managed, higher fee funds.

UCITS, AIFMD and MiFID investment managers should act in the best interests of investors.

What are SMICs and Internally Managed AIFs?

A Self-Managed Investment Company, or SMIC, was once a popular structure for EU funds, in particular UCITS funds, especially where the investment manager was operating from a different jurisdiction to the fund domicile - whether within or outside of the EU. The fund itself had no external Management Company (ManCo) and was dual authorised as both the fund and the UCITS ManCo, relying on the overseas investment manager to carry out the conventional control and oversight functions, including operations, risk management, compliance, financial control, distribution and portfolio management. The roles were often bolstered by a consultancy model, whereby Designated Persons (DPs) were contracted to the fund to provide certain services, typically compliance.

Internally Managed AIFs now face the same challenge of meeting increased regulatory and governance costs, whilst achieving value for money for their investors.

For non-UCITS funds, regulated under the Alternative Investment Fund Managers Directive (AIFMD), the equivalent set up was an Internally Managed Alternative Investment Fund (AIF), with the fund being authorised as both the Alternative Investment Fund Manager (AIFM) and the AIF.

In light of increased substance requirements and recent CBI communications, it is hard to see how either model will remain viable, as evidenced by the fact that no new SMICs or Internally Managed AIFs have been approved by the CBI in recent times. These structures now face the same challenge of meeting increased regulatory and governance costs, whilst achieving value for money for their investors.

So, what needs to change and what are the solutions?

In short, the CBI expects funds structured this way to increase their substance. This can be achieved either by the investment manager establishing a meaningful presence in Ireland, i.e., a proprietary ManCo - or by appointing a Third-Party ManCo.

The Third-Party ManCo model is tried and tested and there are a range of providers of different sizes and capabilities. Core to the model is delegation. Essentially, the ManCo is responsible for the control functions, as set out from an Irish perspective in the CBI's Fund Management Guidance, and typically delegates portfolio management and distribution to the investment manager. The ManCo can slot in alongside existing service providers and help the fund and investment manager fulfil their regulatory obligations.

Where the fund is managed by a large overseas investment manager with plentiful resources, the replication of duties to become EU compliant could seem frustrating, but for those that have underinvested in control and oversight functions, there is a clear and immediate need to change. The one dilemma with this is that by adding the ManCo to the structure, the fund's total expense ratio (TER) increases. For larger funds this may be negligible, but for small and mid-sized funds the impact is likely to be significant.

Solving the SMIC dilemma could result in increased costs. But there is there an alternative solution.

An alternative solution is to move the fund to a fully outsourced model via a fund platform

Size matters. Is your fund sub-scale, but growing rapidly and to plan, or just structurally expensive?

Even with a Third-Party ManCo in place, many funds still struggle with structurally expensive TERs, and asset growth may be taking longer than planned, so an alternative is to consider migrating the fund onto a dedicated fund platform instead.

Most investment managers have a strong philosophy either for or against outsourcing. Many want control and ownership of all decision-making, but there is also a school of thought that outsourcing is simply a better business model, with generally lower costs, significant savings in management time, gaining access to economies of scale and, particularly for new entrants, accelerated times to market.

Is outsourcing a philosophy, or simply a better business model?

There is well-established legislation in Ireland enabling the movement of a sub-fund from one umbrella to another umbrella (under the same regulatory regime), through the creation of a new, legally segregated sub-fund, which then acquires the assets of the existing "transferring" sub-fund. The existing sub-fund is subsequently shut down. Whilst there is no tax implication at the Irish fund level, it is important to take advice on any potential tax implications at the asset or investor level. Typically, for many major markets there are no, or minimal, tax consequences and the immediate and ongoing benefits should outweigh the costs.

In addition to a simplified operating model, a correctly structured move to a fund platform can solve the SMIC dilemma and reduce the fund's TER at the same time, via a substantial reduction in the fund overheads. **Additionally, with the Prescient fund platforms, there is the potential for lower fund administration and other costs**, due to platform synergies and scale that can otherwise only be achieved on a standalone basis by big institutional groups with large fund ranges.

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The result is a more robust business model at much lower costs and, **importantly, the investment manager can carry forward the track record into the new fund.**

The economics of outsourcing: Going it alone, standalone, or platform?

Going it alone (Proprietary ManCo)

- Duplication of functions (if established elsewhere)
- Commitment at a time of (Brexit) uncertainty
- Time to market
- Expensive (management time and $€£)

Platform (Third-Party ManCo)

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- Operationally efficient
- Own brand sub-fund (but platform name in docs)
- Accelerated time to market
- Significant savings (management time and $€£)

Standalone (Third-Party ManCo)

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- Total ownership and control of the fund
- Own branding
- Own service providers
- Third-Party ManCo can fit around your model

Points to consider

- Increased focus on substance
- Level of upfront and ongoing costs
- Ability to have input on strategic matters
- Your outsourcing philosophy

Prescient clients benefit from dealing directly with an experienced team of senior professionals, well-versed in Irish regulations.

Prescient estimates of structural cost impacts on the total expense ratio

Prescient TER estimates suggest **Third-Party ManCo costs could add in the region of 5-20bps to a $50-100m AUM fund, depending on complexity**, whilst for larger funds the TER impact starts to become negligible. Some ManCos charge additional fees for the provision of the required Irish Money Laundering Reporting Officer or for risk services, whilst others include these within the standard offering.

Prescient TER estimates suggest that **Fund Overheads* could be reduced by 50-75% on a vanilla $50-$100m AUM fund, simply by switching to a platform model**. Once legal and tax advice fees are taken into consideration, this could represent a meaningful reduction in the fund's TER, even during year one.

Fund Overheads*	$50m AUM	$100m AUM	$250m AUM	$500m AUM
Fund platform	8-12bps	4-8bps	2-4bps	1-2bps
Standalone fund	32bps +	16bps +	6bps +	4bps +

Source: Prescient TER estimates for illustrative purposes. Actual TERs vary based on nature and complexity of fund and/or commercial agreements.
* Fund Overheads defined as audit, directors, legal advice, corporate secretarial, establishment costs, amortisation, regulatory levies.

Irrespective of whether the fund appoints a Third-Party ManCo on a standalone basis or converts to a sub-fund on a dedicated fund platform, an important additional consideration in future-proofing the relationship is the ManCo's ability to fund the regulatory capital requirement that the UCITS or AIF requires, particularly where significant AUM growth is anticipated.

The Prescient Irish regulated fund platform solutions

Platform Name	Type	ManCo	Fund Administrator and Transfer Agent	Custodian and Depositary
Prescient Global Funds ICAV	UCITS	Prescient	Prescient	Northern Trust
Prescient Global Qualified Investor Fund ICAV	QIAIF	Prescient	Prescient	Northern Trust
Prescient Common Contractual Fund	QIAIF	Prescient	Northern Trust	Northern Trust
White label solutions	Various	Prescient	By agreement	By agreement

Why Prescient Fund Services (Ireland)?

- Provider of Irish regulated UCITS and AIFMD fund platforms
- Standalone Third-Party ManCo and Fund Administration services
- Independent risk management via Prescient Analytics
- Part of a larger diversified global financial services group
- Supports traditional and alternative funds
- Operationally efficient, cost effective and scalable
- Experience: over 20 years in business, over 10 years in Ireland
- Supported by institutional technology
- Leading institutional depositary partner
- Authorised as a UCITS Management Company
- Authorised as an Alternative Investment Fund Manager (AIFM)
- Authorised as a Fund Administrator
- Regulated by the Central Bank of Ireland

Prescient Fund Services is well-positioned to support third-party managers of Irish and other EU passported funds by providing the infrastructure and performing key control functions that are required to help managers to grow their businesses and meet their regulatory obligations.

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About Prescient Fund Services

Prescient Fund Services is an independent global provider of competitive and flexible outsourced management company, platform, and administration services to managers of traditional and alternative investment funds. With over 120 team members and firmwide assets under administration or management in excess of USD 30 billion[i], Prescient Fund Services is well-positioned to support third-party managers of Irish and other EU passported funds by providing the infrastructure and performing key control functions that are required to help managers to grow their businesses and meet their regulatory obligations. Our clients benefit from dealing directly with an experienced team of senior professionals, well-versed in Irish regulations.

About Prescient

Prescient Holdings (Pty) Ltd is a diversified, global financial services group with a 22-year track record of providing solutions to our clients in Asset Management, Investment Administration and Platform Services, Retirement Solutions and Stockbroking. Prescient has successfully operated for 22 years in South Africa, 13 years in Ireland and the UK and 7 years in China.

Regulatory Notice

Prescient Fund Services (Ireland) Limited is regulated by the Central Bank of Ireland. Prescient Fund Services (Ireland) Limited is authorised as a fund administrator, and as a management company pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2011 (S.I. 352 of 2011) as amended and as an Alternative Investment Fund Manager under AIFMD Regulations.

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[i] Effective 31 December 2020