

# AIFMD - Depositary

Directive 2011/ 61/EU on Alternative Investment Fund Managers (**AIFMD**) must be implemented by EU Member States by 22 July 2013. AIFMD is supplemented by a delegated regulation (**AIFMD Regulation**). AIFMD regulates the activities of Alternative Investment Fund Managers (**AIFMs**) and their Alternative Investment Funds (**AIFs**). In respect of safe-keeping of assets, the AIFMD requires the AIFM to ensure that a single depositary is appointed for each AIF it manages.

## Overview

AIFMD introduces significant changes for custodians of Irish non-UCITS funds which will fall under the scope of AIFMD. There are no transitional provisions for depositaries so after the effective date of AIFMD, depositaries must comply with the provisions of AIFMD where they are appointed as a depositary of an AIF by an AIFM. AIFMs that exist at the date of entry into force of AIFMD are expected to use best efforts to comply with AIFMD in relation to depositary requirements.

The standard of liability for depositaries will be a quasi-strict liability standard for loss of financial instruments in custody where such loss is by a sub-custodian appointed by the depositary. There are limited narrow grounds on which the depositary may establish it is not liable for such loss. Additionally the depositary is liable to the AIF, or investors, for other losses arising from the depositary's negligent or intentional failure to properly fulfil its obligations under AIFMD. The AIFMD Regulation sets out certain prescribed contents for the agreement appointing the depositary. For existing funds, this will mean a revision of the custody agreement. There are specific requirements relating to cash monitoring of the AIFs and oversight duties similar to those required of custodians of UCITS funds. This will require an analysis and overhaul of existing custody operational processes and systems. Conditions to be satisfied when delegating safekeeping duties are set out in detail in AIFMD and AIFMD Regulation. Further, specific duties are imposed on AIFMs where a prime broker has been appointed and this will impact depositaries who will have obligations to obtain specific reports on assets held by prime brokers and also will give rise to consideration of the split of liability between prime brokers and custodians regarding AIF assets held and re-used by prime brokers.

The AIFMD and AIFMD Regulation contain requirements for depositaries relating to:

- Eligibility
- Depositary Agreements
- Oversight and monitoring functions
- Delegation
- Prime Broker as delegate
- Liability

## Eligibility

An AIFM must appoint a single independent depositary (which may not be the AIFM itself) in respect of each AIF it manages. A depositary of an EU AIF must be located in the AIF's home member state and must be any of (a) a credit institution; (b) a MiFID investment firm authorised to provide custodial services and which meets certain capital requirements; (c) an entity which, on 21 July 2011, was eligible to act as a depositary under the UCITS Directive (and which is subject to prudential regulation and ongoing supervision).

For non-EU AIFs, the depositary must be established in (a) the same third country as the AIF; or (b) the home member state of the AIFM managing the AIF; (c) the member state of reference of the AIFM managing the AIF.

Specified requirements regarding the appointment of a depositary in a third country must be satisfied.

Prime brokers acting as counterparty to an AIF may act as the depositary for an AIF, subject to functional and hierarchical separation of their depositary and prime brokerage roles, and appropriate management of conflicts of interest. In addition, depositaries of AIFs can delegate custody tasks to one or more prime brokers provided that they meet the conditions above and below.

## Depositary Agreements

AIFMD requires that the appointment of a depositary to an AIF is evidenced in writing. The AIFMD Regulation specifies the following matters which must be addressed in the written agreement between the depositary and the AIFM and/or AIF;

1. a description of the services to be provided by the depositary and the procedures for each type of asset of the AIF that is entrusted to the depositary;

2. a description of the way in which the safekeeping and oversight function is to be performed in accordance with the types of asset and the geographical regions in which the AIF plans to invest;
3. a statement that the depositary's liability will not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with AIFMD requirements;
4. the period of validity and the conditions for amendment and termination of the contract;
5. the confidentiality obligations applicable to the parties;
6. the means and procedures for transmission of information between the depositary and the AIFM or AIF;
7. information on whether the depositary or a sub-custodian may re-use AIF assets and on the conditions of such re-use;
8. the procedures for amending the AIF rules, instruments of incorporation and offering documents;
9. a provision specifying which information must be exchanged between the AIF, the AIFM, any third party acting on behalf of the AIF or AIFM, and the depositary in relation to the sale, subscription, redemption, issue, cancellation and repurchase of units or shares of the AIF and in relation to the performance of the depositary's oversight and control function;
10. a commitment by each party to provide, on a regular basis, details of any third party appointed and, upon request, information on the criteria used to select the third party and the steps envisaged to monitor the activities of the third party;
11. information on the responsibilities of the parties relating to the prevention of money laundering and terrorist financing;
12. information on all cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF, and the procedures to inform the depositary when any new account is opened;
13. details on the depositary's escalation procedures;
14. a commitment by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not sufficient to protect against the insolvency of a delegate;
15. the procedures to ensure that the depositary can enquire into the conduct of the AIFM and/or the AIF and assess the quality of information transmitted (including by accessing the books of the AIFM and/or AIF in on-site visits); and
16. the procedures to ensure that the AIFM and/or AIF can review the depositary's performance of its contractual obligations.

## Oversight and monitoring functions

The duties of the depositary include:

1. monitoring the AIF's cash flows;
2. safekeeping all the assets of the AIF (or AIFM acting on behalf of the AIF) to include:
  - 2.1 holding in custody all financial instruments that can be registered in a financial instruments account and all financial instruments that can be physically delivered to the depositary. Non-physically deliverable financial instruments are to be held in custody where they are:
    - i. transferable securities, money market instruments or units in collective investment undertakings; and
    - ii. capable of being registered or held in an account directly or indirectly in the name of the depositary.
  - 2.2 in respect of all other assets of the AIF, verifying whether the AIF (or AIFM acting on behalf of the AIF) holds an ownership interest in those assets, based on internal and external evidence of ownership;
3. ensuring that the sale, issue, repurchase, redemption and cancellation of units or shares of the AIF are carried out, and that the AIF's income is applied, in accordance with national law and the AIF rules or constitutive documents;
4. ensuring that the value of the shares or units of the AIF are calculated in accordance with national law, the AIF rules and the valuation principles prescribed by AIFMD;
5. carrying out the instructions of the AIFM unless they conflict with the applicable national law or AIF rules or instruments of incorporation;
6. ensuring that in transactions involving the AIF's assets, any consideration is remitted to the AIF within the usual time limits; and
7. ensuring that an AIF's income is applied in accordance with the applicable national law and the AIF rules or instruments of incorporation; and
8. maintaining accurate records in relation to the above functions.

## Delegation<sup>1</sup>

The depositary may not delegate any of its functions described in AIFMD to third parties other than the safekeeping functions. Delegation by the depositary is subject to a number of conditions including that:

1. the tasks are not delegated with the intention of avoiding the requirements of AIFMD;
2. the depositary can demonstrate that there is an objective reason for the delegation;
3. the depositary has exercised all due skill, care and diligence in the selection, appointment and ongoing monitoring of the third party;
4. the depositary must ensure that the third party meets the following conditions at all times during the performance of the tasks delegated to it:
  - a. it has structures and expertise adequate and proportionate to the nature, scale and complexity of the assets of the AIF (or of the AIFM acting on behalf of the AIF);
  - b. in respect of the custody of financial instruments, it is subject to effective prudential regulation (including minimum capital requirements) and supervision in its local jurisdiction and periodic external audits;
  - c. it segregates AIF assets from its own assets and from the assets of the depositary; and
  - d. it does not make use of the AIF's assets without the express consent of the AIF (or the AIFM acting on behalf of the AIF). The third party must act honestly, fairly, independently and in the interests of the AIF and the investors of the AIF when carrying out its duties, and must comply with certain general obligations as set out in AIFMD.

The depositary must comply with specified minimum ongoing monitoring requirements in relation to its delegates.

Where the law of a third country requires that certain financial instruments are held in custody by a local entity and no local entities satisfy the delegation requirements laid down in AIFMD, the depositary may delegate its functions to such a local entity notwithstanding that the requirements have not been met, if certain conditions are satisfied.

## Prime Broker as delegate

Where a prime broker has been appointed as delegate, the agreement appointing the prime broker must contain provisions whereby the prime broker must provide to the depositary of the AIF, no later than the close of the next business day to which it relates, a statement in a durable medium which contains the following information:

1. at the end of each business day, the total value of assets held by the prime broker for the AIF, including:
  - a. cash loans made to the AIF and accrued interest;
  - b. securities to be redelivered by the AIF under open short positions entered into on behalf of the AIF;
  - c. current settlement amounts to be paid by the AIF under any futures contracts;
  - d. short sale cash proceeds held by the prime broker in respect of short positions entered into on behalf of the AIF;
  - e. cash margins held by the prime broker in respect of open futures contracts entered into on behalf of the AIF;
  - f. mark-to-market close-out exposures of any OTC transaction entered into on behalf of the AIF;
  - g. total secured obligations of the AIF against the prime broker; and
  - h. all other assets relating to the AIF.
2. the value of other assets (i.e. not financial instruments) as collateral by the prime broker in respect of secured transactions entered into under a prime brokerage agreement;
3. the value of the assets where the prime broker has exercised a right of use in respect of the AIF's assets;
4. a list of all the institutions at which the prime broker holds or may hold cash of the AIF in an account opened in the name of the AIF or in the name of the AIFM;
5. details of any other matters necessary to ensure that the depositary of the AIF has up-to-date and accurate information about the value of assets the safekeeping of which has been delegated to the prime broker.

<sup>1</sup> Use of securities settlement systems is not considered to be custody delegation for the purposes of AIFMD.

## Liability

The depositary is liable (to the AIF or its investors) on loss of financial instruments held in custody by it or its delegate. A loss of a financial instrument held in custody by a depositary is deemed to have taken place when any of the following conditions is met:

1. a stated right of ownership of the AIF is demonstrated not to be valid because it either ceased to exist or never existed;
2. the AIF has been definitively deprived of its right of ownership over the financial instrument, unless the instrument is substituted by or converted into another financial instrument(s);
3. the AIF is definitively unable to directly or indirectly dispose of the financial instrument.

The depositary is obliged to return identical financial instruments or the corresponding amount to the AIF (or the AIFM acting on behalf of the AIF) without undue delay, even if the instruments were custodied by a delegate of the depositary.

Where the loss of financial instruments has not resulted from accounting errors, operational failures, fraud, failure to apply the segregation requirements at the level of the depositary or a delegate, but has instead resulted from an external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary, the depositary may be able to discharge its liability for the loss provided the depositary can prove that all the following conditions are met:

1. the event which led to the loss is not the result of any act or omission of the depositary or its delegate;
2. the depositary could not have reasonably prevented the occurrence of the event which led to the loss despite adopting all precautions incumbent on a diligent depositary as reflected in common industry practice;
3. despite rigorous and comprehensive due diligence, the depositary could not have prevented the loss. This condition may be deemed to be fulfilled where the depositary has taken all of the following actions:
  - a. establishing, implementing, applying and maintaining structures and procedures and ensuring expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF in order to identify in a timely manner and monitor on an ongoing basis external events which may result in loss of a financial instrument held in custody;
  - b. assessing on an ongoing basis whether any of the events identified under the first indent presents a significant risk of loss of a financial instrument held in custody;
  - c. informing the AIFM of the significant risks identified and taking appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody, where actual or potential external events have been identified which are believed to present a significant risk of loss of a financial instrument held in custody.

If the loss of financial instruments held in custody has been caused by a delegate, the depositary can discharge itself of liability where all of the specified conditions in AIFMD are met.

The depositary shall also be liable to the AIF (or its investors) for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations under AIFMD.

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