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Hedge Fund Law Report
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AIFMD

What Hedge Fund Managers Need to Know About AIFMD's Depositary Requirement (Part Two of Two)

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Among the changes imposed on hedge fund managers by the Alternative Investment Fund Managers Directive (AIFMD) is the European requirement to appoint a fund depositary. Hedge fund managers may be subject to different depositary regimes depending on their and their funds' domiciles, and appointing a depositary requires attention to numerous practical and operational details.

In a recent interview with the Hedge Fund Law Report, Bill Prew, founder and CEO of INDOS Financial Limited, discussed AIFMD's impact on the hedge fund industry since its introduction in July 2014. This article, the second in a two-part series, sets forth Prew's thoughts about the practical implications of the new depositary requirements as well as other industry trends and issues for hedge fund managers. In the first installment, Prew discussed the effect of AIFMD on hedge fund managers and their ability to market funds across Europe.

For more on depositary requirements under AIFMD, see our two-part series "Application of the AIFMD to Non-E.U. Alternative Investment Fund Managers": Part One (May 23, 2013); and Part Two (Jun. 13, 2013); as well as "AIFM Directive: Loosening the Regulatory Noose" (Jun. 17, 2009).

Depositaries

HFLR: AIFMD introduced the role of the "depositary." Can you explain what the depositary's role is and when one needs to be appointed?

Prew: The depositary performs a fiduciary role and must act honestly, fairly, professionally, independently and in the interests of the fund and its investors. The depositary performs a series of mandated duties including the safekeeping of financial instruments; recordkeeping and ownership verification of non-custodial "other assets"; daily cash-flow monitoring; and a range of oversight duties.

The primary focus of the depositary's oversight duties is to ensure the fund is compliant with its prospectus and other constitutional documents. Therefore, these duties include oversight of the fund's valuation; compliance with investment restrictions and AIFMD leverage limits; and proper processing of shareholder transactions, such as subscriptions and redemptions.

The depositary regime which applies depends on a combination of the domicile of the alternative investment fund manager (AIFM) and alternative investment fund (AIF):

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- E.U. AIFMs managing E.U. AIFs are required to appoint a single depositary to perform all duties. The single depositary is able to delegate the safekeeping duties to a sub-custodian, which, in the context of many hedge funds, will involve the delegation to one or more prime brokers. The depositary is required to be domiciled in the domicile of the AIF.
- E.U. AIFMs managing non-E.U. AIFs are caught by the depositary requirements only if they market those funds to E.U. investors through national private placement. The AIFM must ensure one or more entities are appointed to perform the depositary duties in what has become known as the "depositary-lite" regime. In practice what this means is that prime brokers undertake the safekeeping of custodial financial instruments, and a depositary services provider will typically perform the remaining duties.
- Non-E.U. AIFMs managing non-E.U. AIFs are not subject to any depositary requirements under the AIFMD, except where countries such as Germany and Denmark have "gold plated" AIFMD and imposed a depositary requirement. There are some nuances between the German and Danish depositary requirements but they broadly amount to the depositary-lite regime that applies to non-E.U. AIFs. [See "AIFMD Is Easier for Non-E.U. Hedge Fund Managers Than Commonly Anticipated" (Oct. 22, 2015).]

HFLR: Is a manager required to retain a different depositary in every European jurisdiction in which it wants to do business?

Prew: It really depends on the jurisdiction or domicile requirements. Unlike a marketing passport or a Markets in Financial Instruments Directive (MiFID) passport in Europe, there is no depositary passport within the E.U. Therefore, the depositary of an E.U. fund has to be in the domicile of the fund, although a handful of countries, such as Malta, obtained a derogation from the European Commission (EC) until mid-2017 allowing a depositary in another E.U. country to act for the fund during this period.

For example, if you are an Irish depositary acting for an Irish fund, you cannot act for a Luxembourg fund. So by default, if you are a manager with funds in different European domiciles, you're going to have different contractual relationships with providers in different countries. While it might be within the same entity providing the services – *e.g.*, large global banking groups will have depositary operations and licenses in multiple E.U. countries – you will not have the same depositary acting from one location across all your funds.

Conversely, there are no depositary domicile requirements for non-E.U. funds. So a U.S. manager marketing to Germany and Denmark could have a depositary anywhere in the world. In reality, managers in such situations tend to select U.K.- or Irish-based depositaries.

It's also worth noting that a depositary for an E.U. fund needs to be an E.U. Credit Institution or an authorized MiFID investment firm which provides the services of safekeeping and administration of financial instruments. AIFMD does not stipulate that the depositary duties under the depositary-lite model for non-E.U. funds must be performed by a firm that holds any particular regulatory or capital position. Different regulators have however taken different positions, for example:

- The U.K. Financial Conduct Authority (FCA) requires any U.K. firm undertaking any of the depositary duties for non-E.U. Funds to be regulated as an Article 36 Custodian subject to a minimum capital requirement of €125,000.
- The Central Bank of Ireland does not regulate Irish firms undertaking the cash flow monitoring and oversight duties but requires firms performing the safekeeping and other

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assets recordkeeping and verification duties to hold a custody authorization under the Irish Investment Intermediaries Act (IIA). Where an Irish fund administration group authorized under the IIA wishes to perform depositary-lite duties, they must do so from a separate legal entity and put in place policies and procedures to ensure that conflicts of interest are managed appropriately.

HFLR: How much does the introduction of a depositary into a hedge fund manager's business model change the function of the fund or business? In other words, does the use of a depositary alter the way the manager can operate the fund?

Prew: Bear in mind that most European funds or AIFs had a requirement for a trustee/depositary of some kind before AIFMD. The depositary requirements are entirely new for non-E.U. funds, where you have the depositary-lite model. I think across the 50-plus funds to which we provide depositary services, the appointment of a depositary services provider has not altered the way that the manager runs or operates its fund.

The depositary generally undertakes *ex post* monitoring, rather than imposing itself into the fund's trade flow. The depositary does not say "no" to investments that the manager wants to make, although it does perform valuable checks on whether the fund is complying with its prospectus and any investment restrictions.

The depositary functions have never been the remit of the fund administration businesses, so an obvious advantage is that the depositary conducts oversight of the fund's compliance with its investment mandate and any restrictions. This is a value that investors and fund boards are starting to recognize.

For E.U. funds, which are subject to a full depositary model, there are, no doubt, depositaries that have had some market impacts because the depositary requirements are different from those that apply to a non-E.U. fund. Other than a single depositary being required to perform all the depositary duties (of course subject to the ability to delegate the safekeeping duties), the other difference is that a strict liability standard applies to the depositary for loss of a financial instrument for an E.U. fund. As a result, fund depositaries have been unwilling to support some less-developed markets. Some managers that have never been constrained in terms of the markets they can operate in are instead going to have to trade synthetically through one or more swaps (which would typically be regarded as an "other asset" and not subject to the strict liability requirements), as opposed to through financial instruments, such as cash equities and the like.

HFLR: What disclosures do hedge fund managers need to include in their offering documents and marketing materials about the depositary?

Prew: The fund is the principal contracting party with the depositary. The depositary is regarded as a material service provider, and accordingly, the depositary is disclosed in the directory of an offering document. Just as you would have disclosures about the key terms of a prime brokerage or administrator relationship, you would have similar disclosures about the role of the depositary, clarifying the duties that the depositary performs, its duty of care, liability standards and the like.

HFLR: What are the top considerations for a hedge fund manager when evaluating a potential depositary?

Prew: Top of my mind is the growing debate at the moment about the degree to which a depositary should be independent from the fund administrator or other service providers to the fund. A key element of the depositary's role is to oversee the calculation of the net asset value

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(NAV). If the administrator calculates the NAV and an affiliate of the administrator is the depositary, then, effectively, the same group is marking its own homework; there is therefore an inherent conflict of interest in this model.

Many managers acknowledge that, when faced with the volume of work to become AIFMD compliant, they simply opted to appoint an affiliate of their fund administrator despite the inherent conflict of interest. Eighteen months after the introduction of AIFMD, several managers have either already switched or begun to move to an independent depositary provider.

Three quarters of the issues we have flagged in the past 18 months or so have emanated from the fund administrator, and the rest are manager-related issues such as AIFMD leverage breaches or non-compliance with investment restrictions. The issues we have identified highlight that the depositary can perform a valuable role. I think that is why some of the bigger hedge fund consultants are really starting to focus on the role of the depositary, challenging managers to explain the thought process they went through when considering which depositary to appoint.

If a manager simply defaulted to the affiliate of its administrator, the consultants want to know why. Did the manager consider conflicts of interest and how the depositary manages this conflict? What reporting is the manager getting from them? Has the depositary identified and reported any issues? Has the manager actually visited them to undertake due diligence over their systems and processes?

Aside from conflicts of interest, other issues that the manager should consider when selecting a depositary include:

- Type of service model the depositary employs. Specifically, how does the depositary undertake its role? How robust is the oversight of the fund, and how frequently does the depositary review the fund? What reporting and transparency will clients receive?
- Reputation of the depositary in the industry and its commitment to the depositary market.
- Contractual terms with the depositary. Are they balanced? Managers should take care to review the indemnification provisions (*e.g.*, from the fund or the manager), the standard of liability and whether there is any cap on liability (there should not be any).
- Regulatory status. For example, as noted, some depositary-lite providers are not required to be regulated in certain jurisdictions. Would managers prefer a fully regulated firm?
- Balance sheet. This is more relevant for the full depositary to be employed by E.U. funds than it is for the depositary-lite for non-E.U. funds, because of the strict liability that applies for the loss of custodial financial instruments. In many cases, the depositary will seek to discharge its liability to a sub-custodian, and it is important for managers to understand and agree to the model that the depositary will employ.
- Professional indemnity insurance maintained by the depositary.

HFLR: What are the biggest risks encountered by hedge fund managers when hiring a depositary? And how can these risks be mitigated?

Prew: If proper due diligence is undertaken by the manager over the depositary, there shouldn't really be any risks from hiring a depositary. There is a good deal of choice in the market, particularly for depositaries affiliated with the fund administrator. Unfortunately, very few depositaries are willing to act as depositary to an open-end hedge fund where an affiliate is not the fund administrator.

HFLR: Is there much room to negotiate the agreements with a depositary?

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Prew: Since AIFMD became effective, some market standards in depositary agreements have emerged. In practice, a manager can negotiate the agreement. Standard areas that managers focus on include:

- Parties to the agreement (The agreement is usually tri-partite between the fund, manager and depositary, although some firms resist the manager being a party. The fund is the principal party.);
- Clear descriptions of the applicable services and AIFMD regulations;
- Standard of liability (for example, negligence versus gross negligence);
- Caps on liability (as noted, there should not be any);
- Indemnification (usually from the fund only, not the manager);
- Delegation (in particular, where safekeeping duties are delegated); and
- Term and termination.

Agreements are increasingly developing in other areas of general market focus, such as cybersecurity, anti-bribery legislation, etc.

HFLR: If a manager needs to change depositaries, how difficult a process is this? Is regulatory approval or notification required?

Prew: Changing depositaries is actually quite straightforward. The incoming depositary should manage the whole process. No information transfer is required from the old to new depositary.

In the U.K., the FCA requires one month's notification of the switch, as a change of depositary is a "material change" under the FCA rules.

Otherwise, the process generally proceeds according to the following steps:

1. Agree to contractual terms with the new depositary;
2. Provide outgoing depositary notice (which is typically 90 days);
3. Establish information flows between the fund administrator and depositary, as well as between the prime brokers and custodians and the depositary (Administrators and prime brokers are now familiar with the range of reporting and information requirements of the depositary, so this is generally a straightforward exercise that the new depositary will manage.);
4. Enter into a service level document with the new depositary (which sets out the information flow between the various parties);
5. Submit necessary forms to the regulator to notify them of the change;
6. Issue a simple amendment to the offering document.

We have successfully completed several transitions well within the typical 90-day notice period mentioned above.

HFLR: How have fund investors reacted to the introduction of the depositary?

Prew: I think it is fair to say that investors have been slow to come to grips with the impact of AIFMD and the role of the depositary. However, there has been a definite increase in awareness of investors with respect to the role of the depositary and the value that it can add.

The fees for depositary services are paid for by the fund, and investors rightly want to understand what they are paying for. As a result, managers are starting to receive more

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questions about the depositary during investors' operational due diligence processes and, as I mentioned, the larger consultants are also showing much more interest in this area.

HFLR: If investors have responded positively to the depositary, do you envision that they will require hedge funds to use a depositary even if not otherwise required by law or regulation? In other words, will the use of a depositary be something that institutional investors and others insist on?

Prew: Possibly. I have heard some suggestions of this, and I can certainly see the logic of this. However, I am unaware whether this has yet happened in practice.

Some managers have "opted up" from being small AIFM to full-scope AIFM authorization even though they are below the €100 million assets threshold, principally because they believe being subject to full AIFMD compliance will present a more robust governance framework to investors and therefore be beneficial in a marketing sense. In so doing they then need to appoint a depositary, even though this would not have been required if they had remained a small AIFM.

HFLR: What issues have arisen as hedge fund managers have contracted with depositaries? And how have those issues been resolved?

Prew: Issues have broadly fallen into two categories: fund administration related issues; and manager related issues.

Examples of fund administration issues include:

- Securities that are not priced in accordance with the pricing policy;
- Inaccurately accrued expenses or those outside the fund's range of permitted expenses;
- Position reconciliation errors, such as duplicate trades processed and recorded in the NAV;
- Aged or material cash reconciliation items requiring further explanation;
- Incorrect allocation of profits and losses between share classes;
- Anti-money laundering control weaknesses (around investor screening);
- Incorrect processing of shareholder transactions; and
- Cash control weaknesses (*e.g.*, expenses paid out of the wrong fund bank account).

Examples of manager related issues include:

- Breaches of investment restrictions;
- Breaches of AIFMD or other leverage restrictions; and
- General gaps in compliance with AIFMD.

When issues do arise, AIFMD requires depositaries to have a clear plan for escalation to ensure those issues are dealt with promptly and appropriately. An issue would typically be brought to the attention of the chief operating officer of the fund, and there would be a discussion about any remedial action to be taken. Depending on the nature of the issue, it may also be escalated and reported to the fund's board.

Ultimately if the depositary feels appropriate action is not being taken, the matter may be escalated to the FCA or other applicable regulator of the depositary.

All issues are reported in writing in a monthly report to the manager and a quarterly report to the board of the fund. Increasingly, we have found that the fund board expects to be promptly advised of any issues that arise, rather than waiting until the next quarterly board meeting, particularly where the issue highlights control weaknesses.

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Other Industry Trends and Issues

HFLR: What other trends and issues are you currently seeing in the industry?

Prew: The biggest challenge was going to be the revised MiFID directive (MiFID II). However, the introduction date for MiFID II was recently delayed until January 2018, so firms have more breathing space. As mentioned previously, MiFID II will have more impact on how businesses are managed than AIFMD. [See "Hedge Fund Managers May Receive Extra Time to Prepare for MiFID II" (Dec. 3, 2015).]

We are seeing the ongoing impact of the new Basel III capital rules on banks, prime brokers, etc. There has been some pullback from business lines by prime brokers, such as termination of client relationships and banks' unwillingness to hold cash. As a result, some "Tier 2" prime brokers have been able to make inroads. [See "Basel III Raises Prime Brokerage Costs for Hedge Fund Managers" (Feb. 18, 2016).]

Furthermore, there is ongoing consolidation in the fund administration industry. Some banks are exiting the fund administration industry or eliminating smaller relationships. As a result, managers are focusing far more on understanding the strategy and commitment of their service providers.

HFLR: What is the biggest concern on the horizon for hedge fund managers? In other words, what should managers be preparing for, and what steps should they be taking to prepare for it?

Prew: In the short term, the June 23 referendum on whether the U.K. will remain in or leave the E.U. (commonly referred to as the "Brexit") is the biggest matter. This creates uncertainty in the run-up, no doubt causing businesses to delay decision-making. If the U.K. votes to depart the E.U., there will be a two-year period during which it negotiates the terms of its exit from the E.U., creating more uncertainty.

From an AIFMD/financial services industry perspective, it doesn't necessarily follow that if the U.K. were to leave the E.U., AIFMD would cease to apply to U.K.-based managers (*i.e.*, that U.K.-based managers would be treated as non-E.U. third-country managers, like U.S. managers). There is not much that many firms can be doing at present to prepare, because it is so difficult to predict what will happen if there is a "no" vote, and there will be the two-year period to figure things out.

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