

AIFMD – Global Custody Networks for Depositaries

Directive 2011/61/EU on Alternative Fund Managers (AIFMD) includes a number of safekeeping requirements for assets of alternative investment funds (AIF) including the requirement that AIFs appoint a single depositary to safekeep its assets. This is based on the idea that an independent entity should hold or verifies the assets to ensure that investors are protected from any attempts to use AIF assets inappropriately.

The safekeeping requirements make depositaries responsible for both assets of AIFs which it holds itself but also for those assets which are held by other parts of its custody network, including sub-custodians and other delegates.

Safekeeping

Depositaries have a duty to safekeep an AIF's assets, both for financial instruments held in custody and for other assets.

The AIFMD safekeeping requirements apply not only at the depositary level but also down the chain of custody through delegates of the depositary. In general terms, delegates of the depositary's safekeeping obligations would include global custodians, prime brokers, collateral holders and sub-custodians but not CSDs.

The safekeeping functions can be delegated by a depositary to sub-custodians or other delegates provided that:

1. there is an objective reason for so doing;
2. the depositary has no intention of avoiding the AIFMD requirements;
3. due skill care and diligence in appointing the delegate; and
4. the delegate complies with a similar standard of safekeeping

required of depositaries in the AIFMD.

Requirements for AIF asset classes

The AIFMD groups safekeeping requirements into two categories, each category having different duties on depositaries and their delegates.

Financial instruments held in custody

For AIF assets which are financial instruments capable of being held in custody depositaries are required to ensure, at least, the following:

- proper registration of the financial

instruments in the depositary's books;

- maintenance of accurate records and segregated accounts;
- regular reconciliations between the depositary's accounts and those of each sub-custodian;
- exercise of due care in relation to financial instruments held in custody to ensure a high standard of investor protection;
- assessment and monitoring of custody risks throughout the custody chain, and informing the AIF or its manager of any identified material risk;

Key issues

- Depositaries must ensure both (i) the safekeeping of an AIF's financial instruments capable of being held in custody and (ii) verification and record keeping for the AIF's other assets.
- Risks across the entire custody network are taken into account.
- Depositaries may delegate safekeeping to third parties provided certain conditions are met.
- Depositaries will be liable for losses of financial instruments held in custody even when lost elsewhere in the custody chain.

- adequate organisational arrangements to minimise the risk of loss or diminution of the financial instruments; and
- verification of the AIF's ownership right of financial instruments.

As the depository is responsible for complying with the AIFMD's safekeeping duties for financial instruments held in custody, even when it has delegated its safekeeping functions to a sub-custodian, it will also be responsible for ensuring that the delegate (and any sub-delegates) complies with the above provisions (other than ensuring proper registration) so long as the financial instruments remain assets of the AIF.

Other assets

"Other assets" includes anything that an AIF has ownership or rights equivalent to ownership of that is not a financial instrument capable of being held in custody. Other assets are not subject to the same safekeeping requirements as above, instead these are predominantly ownership verification and record keeping.

Ownership verification by a depository or its delegate must be based on information or documents provided by the AIF or its manager and, where available, on external evidence.

Depositaries are also required to keep records of assets owned by the AIF up to date and be able to provide at any time a "comprehensive and up-to-date inventory of the AIF's assets". Neither the AIFMD nor its delegated regulation states that the depository must maintain the inventory itself, nor do they give guidance as to how frequently this inventory should be updated. However, it is unlikely that real time updating is required.

Delegating safekeeping

When a depository selects a delegate that delegate must meet all of the safekeeping and/or verification and
126920-3-8591-v2.0

record keeping requirements as the depository itself (other than ensuring the proper registration of financial instruments held in custody). Depositaries must conduct sufficient diligence on the ability of the delegate to meet such obligations. In addition, depositaries must establish an ongoing monitoring process to ensure that delegates are meeting the AIFMD requirements. This procedure must be reviewed regularly and at least once a year, although this does not necessarily mean that full due diligence must be carried out each year on delegates.

When a depository monitors a delegate's performance and compliance, the AIFMD requires that the depository must be ensured that the delegate exercises a high standard of care, prudence and diligence in the performance of its custody tasks (and in particular that it effectively segregates financial instruments in line with the AIFMD segregation requirements, and that the delegate has reviewed the custody risks associated with it performing safekeeping functions.

A depository cannot delegate safekeeping functions to a third party if there is a likelihood of a conflict of interest between the delegate and the AIF. This may arise, for example, when delegating safekeeping to a prime broker. In such circumstances the depository must ensure that the delegate has functional and hierarchical separation between its prime broker business and its custodial business.

Depositaries are also required to devise contingency plans for each market in which they appoint a delegate. This contingency plan must include the identification of an alternative delegate, if any.

Loss Liability

The AIFMD makes a depository responsible for loss of financial

instruments held in custody regardless of whether the depository has delegated the safekeeping of the assets to a sub-custodian, unless the loss is caused by an "external event" which the depository has taken reasonable steps to avoid. What steps are considered reasonable are determined on the basis of sufficient due diligence by the depository.

Loss of a financial instrument held in custody by a depository, or by a sub-custodian/delegate, will be deemed to have occurred if:

- the AIF's stated right of ownership is demonstrated not to be valid because it has either ceased to exist or never existed;
- the AIF has been definitively deprived of its right of ownership over the financial instrument; or
- the AIF is definitively unable to directly or indirectly dispose of the financial instrument (even though the financial instrument exists and is still held for the AIF).

The loss of a financial instrument held in custody by a sub-custodian due to its failure to meet the safekeeping requirements or insolvency would be an "internal event" giving risk to potential liability of the depository if financial instruments held at any stage in the custody chain are lost (but not a CSD, as it is not considered a delegate so a loss by it would be considered an "external event").

This briefing paper is part of a series of five papers which summarise key issues that the AGC has been considering in relation to the AIFMD.