

AIFMD Review – the key areas of focus for depositaries

On 22 October 2020, the European Commission launched a public consultation on the review of the Alternative Investment Fund Managers Directive (the **AIFMD Review**). The public consultation follows the European Commission's review report from June of this year where the Commission stated that the provisions governing the functions and liability of depositaries had been effective elements of the regime for promoting investor protection, although there are areas that could benefit from targeted clarifications. The Commission also highlighted their concerns regarding the lack of a depositary passport, particularly in smaller markets.

In this bulletin, we highlight the areas where the Commission believes targeted changes are required and discuss how any subsequent proposals for revising the regime could impact depositaries.



Background

The AIFMD aims to protect investors by requiring alternative investment fund managers (**AIFMs**) to act with the requisite transparency before and after investors commit capital to a particular alternative investment fund (**AIF**).

Conflicts of interest must be managed in the best interest of the investors in the AIF. AIFMs must also ensure that the AIF's assets are valued in accordance with appropriate and consistent valuation procedures established for an each AIF. The AIF assets are then placed in safekeeping with an appointed depositary that also oversees AIF's cash flows and ensures regulatory compliance.

The AIFMD does not regulate depositaries in the same way as it regulates AIFMs. Depositaries are not required to become registered under the AIFMD. Instead, the AIFMD sets out the types of firms that may act as depositaries, the functions which a depositary must perform and the circumstances in which a depositary is liable for causing loss to investors, the AIF or the AIFM. It is the AIFM that is responsible for ensuring a depositary is appointed in accordance with the requirements of the AIFMD for each AIF it manages.

Since the AIFMD came into force and the introduction of a number of regulations post the financial crisis (eg EMIR and the resulting initial and variation margin requirements), institutions have been required to focus more intensely on their collateral management practices, expanding the use of collateral, increasing the frequency of assessment and maximising the values of collateral exchanged. Increasingly, buy-side market participants have turned to the triparty model where the triparty agent (acting as a neutral party) manages the collateralisation of exposures resulting from trading activities between two counterparties.

Given the increased demand for the tri-party model and the launch of a number of tri-party platforms, it is not surprising that much of the Commission's consultation focuses on the provision of these services and whether they should be regulated by the AIFMD.

The Commission's Review – areas of focus

Article 69 of the AIFMD requires the Commission to review the application and the scope of the AIFMD. This entails assessing the Directive's impact on investors, AIFs, AIFMs in the EU and in third countries in order to establish how far the objectives of the AIFMD have been achieved. In June 2020, the Commission published its long awaited report on its review of the AIFMD. Running to only 11 pages, the [report](#) was not as detailed as many within the industry had anticipated but it does provide an indication where the Commission believes changes are required.

In relation to depositaries, the Commission concluded *"a dedicated regime regulating functions and liability of depositaries has proved to be an effective measure for enhancing investor protection. It is functioning well, even though targeted clarifications may be necessary to address situations where AIFMs use tri-party collateral management or when central securities depositaries (CSDs) act as custodians"*.

The report goes on to conclude that a more significant issue relates to the lack of a depositary passport, which is at odds with the spirit of the single market. Due to the limited choice of service providers in smaller markets, the Commission states that there are fears of concentration risk where a single depositary could hold the assets of all AIFs established in a Member State.

In August 2020, ESMA sent a [letter](#) to the Commission listing out the issues it considered important to be taken into consideration during the AIFMD Review. In relation to the depositary passport, ESMA noted that there has long been a discussion in the EU on the merit of a depositary passport, "since the UCITS II debate in 1993 at least". While not recommending the creation of such a passport in the AIFMD and UCITS Directives, ESMA believes the Commission may study the benefits and risks further in the context of the AIFMD Review.

The Commission's consultation – legislative change?

The Commission states that greater clarity on stakeholders' views of the AIFMD rules on depositaries is sought in particular where such rules may require clarification or amending. It states that the introduction of the depositary passport is desirable from an internal market point of view, but that stakeholders are invited to propose other potential legal solutions, if any, which could address the issue of the short supply and concentration of depositary services in smaller markets.

Depositary regime

Given the increase in the use of the tri-party model in recent years, it is unsurprising that a key focus of the Commission's consultation paper is the provision of tri-party collateral management services and whether the AIFMD framework should be updated to specifically define those services and provide more specific rules for the delegation process, where the assets are in the custody of tri-party collateral managers. However, a balance will need to be struck between more granular and intrusive regulation of tri-party services and the efficiency of collateral management that such services are designed to achieve. An overly onerous and operationally-heavy regime could hinder the collateral management efficiency that is the very essence of such services.

If stakeholders suggest that the AIFMD framework should be revised to incorporate new rules on tri-party collateral management services, the Commission is keen to understand which aspects should be explicitly regulated by AIFMD, for example:

- the obligation for the asset manager to provide the depositary with the contract it has concluded with the tri-party collateral manager;
- the flow of information between the tri-party collateral manager and the depositary;
- the frequency at which the tri-party collateral manager should transmit the positions on a fund-by-fund basis to the depositary in order to enable it to record the movements in the financial instruments accounts opened in its books; and/or
- any other element.

More generally, the Commission is also keen to understand what difficulties, if any, depositaries face in exercising their functions in accordance with the AIFMD.

Prime brokers

A prime broker acting as a counterparty to an AIF may be appointed as the depositary for the AIF provided that it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker, and that potential conflicts of interest are properly identified, managed and disclosed to the investors of the AIF. In addition, depositaries of AIFs can delegate custody tasks to one or more prime brokers provided that they meet certain conditions, and in practice depositaries will require a transfer of the liability for loss of the AIF's assets to the prime broker.

Where a prime broker has been appointed as sub-custodian, it 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:

- at the end of each business day, the total value of assets held by the prime broker for the AIF, including:
 - the value of other assets (ie not financial instruments) as collateral by the prime broker in respect of secured transactions entered into under a prime brokerage agreement;
 - the value of the assets where the prime broker has exercised a right of use in respect of the AIF's assets;
 - 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; and
 - 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.

The Commission is asking for stakeholder views on whether these rules are clear and whether depositaries face any difficulties in obtaining the required reporting from prime brokers? If difficulties are identified, stakeholders are requested to suggest additional measures that are necessary at the EU level to address those difficulties.

This question will not come as a surprise to the industry. In April this year, Delegated Regulation (EU) 2018/1618 began to apply which beefed up the requirements to contractually ensure a sufficient flow of information between the depositary and the custodian/sub-custodian. Arguably, this focus on the reporting obligations for prime brokers is a continuation of the Commission's desire to strengthen the flow of information.

Depositary passport

As referenced by ESMA, the call for a depositary passport in the context of the UCITS regime has been one that has been made since the regime came into being. Both UCITS and the AIFMD require the depositary to have its registered office or a branch in the same country as the fund. Non-EU AIFs can have a depositary established in the relevant third country only if certain additional conditions are met. The introduction of a depositary passport would allow for the cross-border provision of depositary services, based on a harmonisation of depositary obligations which at present often differ across Member States.

In the context of revisions to the UCITS regime, the Commission published a consultation paper in 2012 asking whether managers encounter problems stemming from the regulatory requirement that the depositary and the fund need to be located in the same Member State. A number in the industry responded calling for a passport to be introduced and stated that the argument for introduction was strengthened by:

- the establishment of ESMA;
- ESMA's role in ensuring harmonisation in regulatory and supervisory practices across the EU; and
- ESMA's ability to intervene in circumstances where there has been a breach of EU law in relation to the UCITS Directive.

This consultation paper once again sees the Commission re-focusing on the possible benefits of a depositary passport. Stakeholders are being asked to clarify whether the lack of a passport inhibits the efficient functioning of the EU AIF market, what the current barriers are precluding an introduction and what the potential benefits and risks could be if those barriers are overcome.

The Commission is also particularly concerned about the lack of choice of service providers in smaller markets (and therefore the potential concentration risk) and as a result is asking for views on whether there are other options that could address the lack of supply in those markets.

Investor Central Securities Depositories (CSDs)

The final question posed by the Commission focuses on whether investor CSDs should be treated as delegates of the depositary. In 2017, ESMA issued an [opinion](#) which considered this point and acknowledged that Recital 21 of UCITS V contemplates that the holding of securities at the investor CSD (as opposed to the issuer CSD) is a delegation of custody functions and it would seem therefore that depositary delegation requirements should apply in this instance. ESMA invited the EU institutions to consider legislative clarifications in both the UCITS and AIFMD framework in order to prescribe the delegation rules to CSDs, in their capacity as investor CSDs.

Contacts



Damian Carolan
Partner – London
Tel +44 20 3088 2495
damian.carolan@allenoverly.com



Bob Penn
Partner – London
Tel +44 20 3088 2582
bob.penn@allenoverly.com



Nick Bradbury
Partner – London
Tel +44 20 3088 3279
nick.bradbury@allenoverly.com



Sylvia Kierszenbaum
Partner – Belgium
Tel +32 3 287 74 10
sylvia.kierszenbaum@allenoverly.com



Alexander Behrens
Partner – Frankfurt
Tel +49 176 17941400
alexander.behrens@allenoverly.com



Salvador Ruiz Bachs
Partner – Madrid
Tel +34 91 782 99 23
salvador.ruizbachs@allenoverly.com



Ellen Cramer-De Jong
Partner – Amsterdam
Tel +31 20 674 1468
ellen.cramerdejong@allenoverly.com



Brice Henry
Partner – Paris
Tel +33 1 40 06 53 66
brice.henry@allenoverly.com



Oonagh Harrison
Senior PSL – London
Tel +44 20 3088 3255
oonagh.harrison@allenoverly.com

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