Link’n Learn

AIFMD Implementation

Depositary webinar

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Leading business advisors
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AIFMD overview

AIFMD Depositary regime

- Applies to EU AIFs managed by an EU AIFM (July 2014 at latest)
- Depositary functions must be carried out by one or more entities for a non-EU AIF with EU AIFM
- To access the EU passport in 2015, non-EU AIFs will need a depositary
- By 2018 all funds in scope that are marketed into Europe will need to appoint a depositary
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Overview of AIFMD depositary regime
AIFMD depositary regime – Key features

- General oversight
- Segregation obligation
- Due diligence
- Valuations and subs/reds verifications

Safekeeping

- Strict depositary liability
- Financial instruments in custody
- Other assets
- Delegation
- Look through

Oversight

Cash monitoring

- Overview of all cash accounts
- Ensure cash is booked
- Reconcile cash flows

Key impacts

- Increased operational oversight
- Complex prime broker relationship
- Increased operational integration between fund admin and the depositary
- Increased cost
- Limitations on investment strategy?
Depository liability regime
## Safekeeping rules

<table>
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<th>Custody</th>
<th>Other assets</th>
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<td>- Listed securities</td>
<td>• Target funds shares (in cases where local regulation requires to record shares of funds with the name of investors)</td>
<td>• Cash collateral</td>
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<td>- Physical securities</td>
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<tr>
<td>- Target funds shares (except when local regulation requires to record shares of funds with the name of investors)</td>
<td>• Listed futures and options</td>
<td>• Time deposits / Third party time deposits</td>
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<tr>
<td>- Loan certificates/loan contracts</td>
<td>• Private Equity direct investments</td>
<td>• Third party fiduciary deposits</td>
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<td>- Target funds with capital commitments</td>
<td>• Non-securitised loans</td>
<td>• Spot exchange</td>
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<tr>
<td>- Non-cash collateral given (if no transfer of property)</td>
<td>• Real estate direct investments</td>
<td>• Fiduciary time deposits</td>
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<tr>
<td>- Collateral received</td>
<td>• Collectible assets direct investments</td>
<td></td>
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<tr>
<td>- Physical certificates in vault that can be safe kept and have ISIN, WPKN, etc.</td>
<td>• Forwards</td>
<td></td>
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<tr>
<td>- Commercial papers</td>
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### Rule

- **General rule (1):** The following if they are capable of being registered or held in an account directly or indirectly in the name of the depositary.
  - Transferable securities
  - Money market instruments
  - Units of collective investment schemes
- **General rule (2):** Financial instruments that can be physically delivered to the depositary shall always be included in the scope of the custody duties of the depositary.
- **Exemption:** Financial instruments if in accordance with applicable national law, are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or a transfer agent, shall not be held in custody.
Constructing liability

The depositary shall be liable to the AIF or to the investors of the AIF, for the loss by the depositary or a third party to whom the custody of financial instruments held in custody has been delegated. The depositary’s liability shall not be affected by any delegation.

The depositary shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

Liability discharge is possible if it passes a series of tests:
- Ability for claim to be taken by AIF or AIFM
- Objective reason
- Anti avoidance
- Due diligence
- Delegate expertise
- Segregation
- 3rd country test
- Other contractual

The provision of services as specified by Directive 98/26/EC by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems shall not be considered a delegation of its custody functions (i.e. and therefore no associated liability).
Placing liability

Depositary

Liable in the first instance unless it can prove otherwise.

If depositary “discharges” liability down the custody chain it can fully escape liability.

If depositary asked for a contractual “indemnity” from it’s sub-custodian or prime broker then it still remains liable under the directive but has managed the liability contractually.

Prime Broker

Where prime brokers hold “custody” assets they would be a “sub-custodian” of the depositary, unless they are a depositary themselves.

Global custodian / sub-custodian

Various operational provisions apply to the sub-custodian (i.e. segregation) but liability rules only apply when there is a “discharge” of liability or where contractual arrangements are in place.
Prime broker models

A
Depositary delegates to the prime broker who then uses its internal sub-custody network

1

PB

→

Dep

→

PB

SUB

AIF

AIFM

2

PB

→

Dep

→

PB

SUB

AIF

AIFM

B
Depositary delegates to the prime broker who then uses the depositary’s internal sub-custody network

1

PB

→

Dep

→

PB

SUB

AIF

AIFM

2

PB

→

Dep

→

PB

SUB

AIF

AIFM

Key
Delegation → Operational change
Indemnification → Extent of risk
Liability discharge → Extent of risk
Will price & risk drive market concentration / movements?

- **Counterparty risk (AIFM):** Where does the AIFM come out on the price / counterparty risk equation?
- **Counterparty risk (PB):** Are the prime brokers comfortable with counterparty (collateral) risk if assets are held outside their network?
- **Asset location:** How does the risk perception change depending on the location of assets?
- **Current client base:** How much “cross selling” occurs within the depositaries
- **Relationship:** Who owns the relationship with the client?
- **Current risk perception:** What level of risk do the depositaries and prime brokers think that they are currently assuming?
- **Operational challenges:** Due diligence / segregation / monitoring
Other key duties and operational aspects
Safekeeping of “other assets”

Ownership verification and record keeping

Access information without undue delay

Produce a “comprehensive and up-to-date inventory” of assets at any time

Non-credit institution depositary

- Member state flexibility to permit a non-credit institution depositary for other assets
- 5 year lockup
- Generally no investment in custody assets
- Foreseen for private equity and real estate

Opportunity for PE and RE administrators

- Leverage existing expertise
- Leverage existing relationships
- Ability to serve small structures profitably
- Treatment of custody assets
Cash monitoring

Appropriate cash accounts

Ensure…opened with entities referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC and which are subject to prudential regulation and supervision that has the same effect as Union law

Reconciliation

Implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis

End of day check

Implement appropriate procedures to identify at the close of business day significant cash flows

Review / monitor procedures

Review periodically the adequacy of those procedures… Monitor on an on-going basis the outcomes of the reconciliations

Own records

Check the consistency of its own records of cash positions with those of the AIFM…using 3rd party data

Data feeds from PB to Depositary

Duplication of fund admin work

Lengthen end of day reconciliation process

How far to look down PE/RE structures?

Own independent reconciliation

How much control reliance?
Depositary – additional requirements

Contractual particulars

Non-EU depositary

General oversight requirements

Frequent verifications and reconciliations

Sub/reds and valuations checks

Safekeeping look-through

Delegation of depositary safekeeping

- Rigorous & comprehensive due diligence
- Country framework
- Adequate practice, procedures and internal controls
- Financial strength and reputation
- Operations and technology
- Custody risk
- Compliance monitoring
- Contingency plans

Segregation

- Maintain segregation throughout the network
- Easily distinguish assets of AIF at any time
- Record, organisational arrangements, regular reconciliations
- If local insolvency rules are deemed insufficient, to ring fence asset, the depositary must assess what “additional arrangements” can be applied
Depositary lite

- EU AIFM / non-EU AIF with private placement until 2018 (typically UK AIFM with Cayman AIF)

- Depositary Lite = Safekeeping + Oversight + Cash Monitoring (no strict liability)
Future depositary landscape
Depositary landscape

Strengths

- Base clients
- Track Record
- Size of organisation
- High barriers to entry
- Internal relationships
- Experience

Weaknesses

- No depositary passport
- Inexperience with different fund operations
- Current system enhancements required
- Short time Frames
- Bundles packages
- Increased liability
- Increased costs
- Specialists
- Increased diligence requirements

Opportunities

- Cross-border harmonisation (UCITS V & VI)
- Increase Revenues
- Funds appointing a depositary for the first time
- Strategic alliances M&A
- Seen as "market leader"
- New services

Threats

- Different jurisdictions
How are depositaries preparing for AIFMD?

- Transitional arrangements
- Sub custody risk assessment
- Contractual negotiations and pricing
- Prime broker models
- Operational due diligence and cash monitoring
- Unintended consequences?
Presenters

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