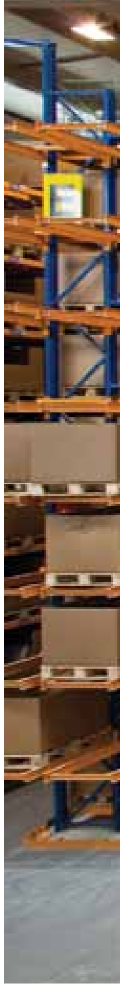

The Special Depositary
Between opportunities and challenges

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The AIFMD (Alternative Investment Fund Managers Directive) is an important piece of regulation that brings the world of alternative investments under a single roof.

One of the centrepieces of AIFM is an extensive set of requirements for depositaries of assets, covering their duties and liability. They considerably reinforce the conditions for the delegating of safekeeping duties over an Alternative Investment Fund's (AIF) assets, the selection and monitoring of these service providers and the supervision of assets with full liability for the depositary in the event that financial instruments held in custody are lost.

Acting as a depositary for an AIF means facing considerable changes and challenges but is also an excellent opportunity for new business models to emerge in a world that is becoming more complex and more demanding. Our aim is to highlight some of the challenges and opportunities in this article.

A wide universe of assets

The universe of investments that can be made by AIFs is driven by the appetite of investors to invest in different and very diverse types of assets. Many of these assets are actually not financial instruments at all.

Understanding the nature of asset classes is an important starting point when it comes to looking into the opportunities and challenges for special depositaries. Furthermore, the general duties of the depositary differ depending on whether an AIF holds financial or non-financial assets and the lines between both asset classes are not as clear-cut as they seem. Depositaries and asset servicers are therefore well advised to fine-tune their understanding of these definitions, and to draw clear lines:

Duties of the Depositary

For financial assets:

- Ensure proper registration of assets
- Maintain accurate records and segregated accounts, in particular recording correspondence with financial instruments and cash held for AIFs
- Conduct regular reconciliations between the depositary's internal accounts and records, including those of third party delegates
- Ensure due care and high standard of investor protection for financial assets held in custody
- Assess and monitor relevant custody risks throughout the custody chain and keep AIFM informed of identified material risk
- Introduce adequate organisational arrangements to minimise the risk of loss or diminution of assets, or rights in connection with the assets caused by fraud, poor administration, inadequate registering or negligence
- Verify AIF's ownership right or ownership right of the AIFM acting on behalf of the AIF over the assets

'Full' safekeeping

For non-financial assets:

- Not safe kept by the depositary but partial safekeeping delegated to a relevant third party entity
- Ownership verification of the AIF's assets
- Record keeping duties for the AIF's assets
- Reconciliation of AIFM instructions

Ownership verification & recordkeeping

Definitions:

A **financial** asset is a title of ownership instanced by the notion of a transferable security. It follows that this title of ownership in either material or de-materialised form may be held in safe keeping.

- The market is currently seeking to clarify these definitions
- As the definitions are not yet fully clear, implementing guidelines will also be necessary

A **non-financial** asset is a contract or a right of ownership evidenced by a contractual transfer of ownership or a right of entitlement to property that is not materialised by a transferable security. As such, the existence of this contract or title is the operable concept rather than any notion of validity as to where that contract is physically held.

Welcome to complexity

Non-financial assets are by nature very diverse and have their very own particularities. In fact, there are virtually no limitations to the scope of non-financial assets.

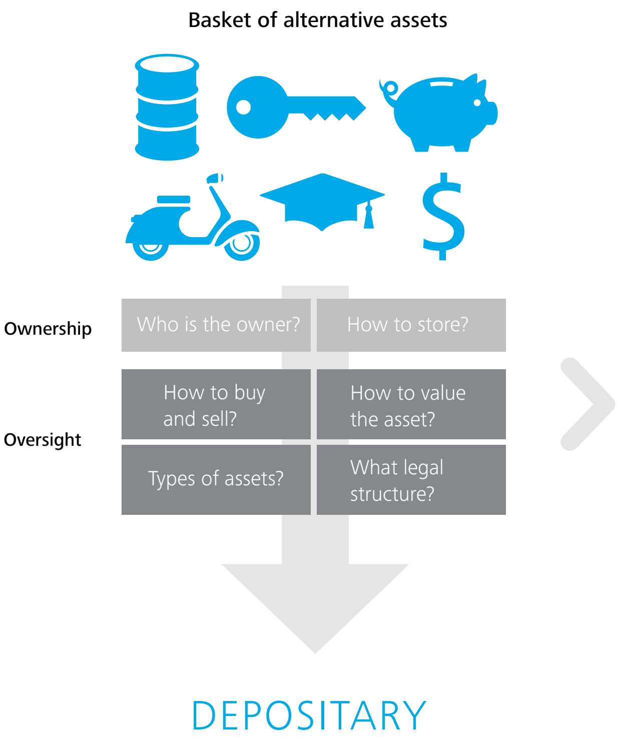
With this diversity comes an increased, if not exponential, complexity in ensuring that the depositary knows where the assets are at all times and can ensure that the AIF has full ownership of them and that the assets are kept safe.

How do you buy a race horse and how is ownership evidenced in a secure way? Which intermediaries are involved in the transaction and is there a central and public register that can hold up in court? How does this differ from one country to another? How can you be sure that the race horse named in the ownership titles is actually the race horse standing in the stables? How should the race horse be looked after so that it keeps its value?

Which stables are suitable and offer the best protection for the horse, and how can the stable be monitored in order to ensure that the race horse does not disappear or become injured or sick? How is the value of a race horse established, and which factors influence the value and hence call for a re-assessment of its value?

The entire thinking, acquisition and record-keeping process initially designed for financial products needs to be adapted to such an asset class. Ultimately, investors should benefit from equivalent due diligence from the depositary regardless of whether their assets are financial instruments or not.

Answers to these questions might sound obvious. They are not. Addressing them in a professional manner across the entire value chain and in line with the notion of a depositary of assets under AIFMD requires the thorough understanding of a highly specialised service provider and robust processes that are fully adapted to the specific needs of an asset class. Both large banks and small firms will face considerable operational challenges in order to meet special depositary requirements.



BUY

- Can the assets be warehoused?
- What intermediaries or agents are typically involved in the transaction
- Is the asset typically originated at a transaction, transferred or both possible?
- How is the transaction typically documented?
- Where the asset is acquired through transfer, what are the recommended pre-transaction existence and ownership checks, if any?
- At which stages are payments required?
- How is the successful conclusion of the transaction evidenced?
- What confirmations/reports/notifications are typically provided following successful conclusion of the transaction, if any?
- Is the ownership evidenced through public records?

HOLD

- How can ownership be independently verified?
- What additional safeguards are recommended, where ownership is evidenced through private records?
- Is there any asset-specific ownership verification frequency required, independently of the underlying fund structure/terms?

SELL

- If disposal operates differently than the acquisition, what elements are to be considered other than the inversion of counterparties and processes compared to the acquisition?
- What confirmations/reports/notifications are typically provided following successful conclusion of the exit transaction, if any?

The emergence of the new PFS status…

Dealing with financial assets and ensuring that title of ownership is always clear is part of the day-to-day business of credit institutions. But the sheer diversity of non-financial assets creates many challenges and complexities for depositaries who must fulfil their duties in an AIFMD environment. Indeed, specialists need to be called upon when it comes to non-financial assets.

AIFMD gives member states the option to allow the depositary of certain AIFs to be a professional entity which does not necessarily qualify as a bank or an investment firm.

With the transposition of AIFMD into Luxembourg law through the law of 12 July 2013, Luxembourg has exercised this option by introducing a new category of specialised PFS (Professional of the Financial Sector) to the Financial Sector Act of 5 April 1993. The new category is called 'professional depositary of assets other than financial instruments', or more commonly 'special depositary'. To this end, article 26-1 has been added to the Financial Sector Act.

As diverse as non-financial asset classes might sound and appear, they have a set of common needs and this is where the special depositary comes into play—the requirement to ensure that the AIF has a clear title of ownership to the assets that is properly registered and documented and that, above all, the assets are safeguarded in order to preserve them. Obviously, preserving race horses is a totally different business to preserving fine wines, and needs a completely different understanding and infrastructure in order to ensure that they are kept safe in line with legal requirements.

Furthermore, the complexity of tasks to be performed by the special depositary is often increased by the use of complex financial engineering arrangements, where assets are held indirectly by the AIF through special purpose vehicles (SPVs).

Asset types and likelihood of positioning for a Depositary							
		Depositary					
Type of assets	Example of assets	Major players specialised in asset servicing			Niche players		
		H	M	L	L	M	H
Financial assets	Shares						
	Bonds						
	UCI units						
Non-financial assets	Private Equity						
	Real Estate						
	Life settlement policies						
	Gold						
	Diamonds						
	Infrastructure						
	Watches						
	Art/Paintings						
	Intellectual property						
	Race horses						
	Petrol						
	Fine wines						

… provides the AIF with several options to appoint a depositary

The creation of the special depositary licence gives AIFs several options when appointing a depositary and they also call for credit institutions to rethink their business models. The special depositary can either be appointed directly by the AIF, or act as a delegate of the AIF's single depositary. It may, however, only be appointed as a special depositary of Specialised Investment Funds (SIF), of Investment Companies in Risk Capital (SICAR) and other Luxembourg or foreign AIFs as per the AIFMD, provided that these have no redemption rights exercisable for at least five years from the date of the initial investment and mainly invest in assets that cannot be held in custody or invest in issuers or non-listed companies as a means to acquiring control over these.

A key element in identifying whether a depositary and/or a special depositary may be appointed obviously lies in what the AIF invests in.

An AIF mainly investing in financial assets will probably appoint a credit institution with a network of cash correspondents and sub-custodians as its single depositary.

But does a credit institution also have enough knowledge and the appropriate organisational structure to deal with assets such as race horses, fine wines, diamonds or physical petrol? Probably not, not to mention the fact that preserving race horses is a totally different ball game than preserving fine wines and needs a completely different understanding and infrastructure to ensure that they are kept safe in line with legal requirements.

So where do we draw the line? Will the AIF have to appoint a credit institution as depositary, which in turn delegates the part of its duties relating to non-financial assets to a special depositary? Or can the AIF actually choose not to appoint a credit institution at all as depositary?

Under EU Regulation 345/2013 of 17 April 2013 on European Venture Capital Funds (EuVECA), qualifying funds must invest at least 70% of their assets in venture capital or private equity and actually do not need to appoint a credit institution as depositary.

On the basis of this, we consider that AIFs investing at least 70% of their assets in non-financial instruments should be able to appoint directly a PFS as its special depositary.

The supervision of financial assets requires that a standard network of sub-custodians and cash correspondents be set up and maintained for assets which are not part of the core activities of a PFS. By delegating the safekeeping of these assets to a credit institution, the PFS could focus its attention on a niche market by supervising non-financial assets.

Dealing with financial assets and ensuring that title of ownership is always clear is part of the day-to-day business of credit institutions

Banks and PFS's need to position themselves

Many AIFs have for long not been required to appoint a depositary. This has now changed with AIFMD being in force since 22 July 2013 and has placed a considerably large number of funds under stringent regulations. As a result of EU-wide access of AIFs to investors and the requirements of the AIFMD, there is a considerable business opportunity for service providers, provided they carefully evaluate how to place their bets:

- Banks will need to understand the current and future needs of their clients and decide whether to stick to the traditional safekeeping of financial assets or seize the considerable business opportunities offered by servicing non-financial assets.
- PFS's are much smaller players, often well established in the alternative investments space. Their smaller size allows them to easily adapt to new needs, and offer tailor-made services focusing on the specific needs of AIFs. Seizing the opportunities offered by the new special depositary means positioning itself as the best possible partner of AIFs or credit institutions for that array of non-financial assets.

  Furthermore, the broad framework provided by the Financial Sector Act actually allows a PFS to combine the special depositary licence with other licences, such as registrar and transfer agent, fund administration, domiciliary and corporate agent, or communication agent, and hence offer a comprehensive end-to-end solution to its clients.
- The new special depositary licence, in combination with the reputation of Luxembourg as a service centre of excellence and a hub for international distribution, will in our view make it more attractive for new players to enter the market fight for market share.
- Banks, PFS's and new market entrants alike are well advised to carefully evaluate which part of non-financial assets they want to specialize in, as covering too many distinct asset classes risks diluting its competence in servicing them properly.

Although the AIFMD distinguishes between financial instruments and non-financial instruments held by an AIF, a single depositary can obviously hold both. However, given the complexity and the need to specialise illustrated above, there is considerable demand for specialised providers.

We particularly see the competitive advantage of crafting a holistic service proposal of several licences and offering comprehensive solutions tailored to the needs of an AIF.

	Major bank players	Niche players	Unconventional players
Strengths	• Larger capacity; integrated approach with full scale service offering • Infrastructure to attract and absorb critical mass • Larger network and broader client base to leverage marketing and relationships • Ability to acommodate lower fees or subside some services	• Dedicated personnel; more customer focus • Flexibility in offering customised services • Strong player among smaller asset/wealth managers and family offices	• Entering the regulated fund market and competing with banks • Often strong expertise in unregulated market (e.g. Soparfi) • Expertise in local regulatory reporting and accounting • Flexibility in offering customised solutions
Weaknesses	• Limited service customisation or inertia in delivering on promises • Lesser customer focus	• Limited network; difficulty to attract critical mass • Limited range of service offering • Difficulty to compete with lower administrative costs of larger competitors	• Lesser automation; processes are generally manual; i.e., less efficient • Limited range of service offering (e.g. no custody services)

What is in it for Luxembourg?

Luxembourg is a well-established financial centre for servicing investment funds. The presence of a vast array of custodian banks, fund administrations, consulting firms and support service providers creates a unique environment of excellence and know-how that combines multilingual staff with experience in servicing funds from all over the world and covering all asset classes.

Luxembourg's creation of the special depositary licence as an extension of the Financial Sector Act addresses this market need perfectly. Now it is up to market participants to identify the potential, define their value proposition and above all position themselves as a provider of choice. Custodian banks, established PFS's, niche players as well as new market entrants should start preparing now.

How Deloitte can help?

Deloitte helps AIFMs in navigating through the regulatory challenges of obtaining a licence, distributing their funds in the countries of choice, and adapt the product range to the new requirements.

We help service providers, such as PFS's and credit institutions, in defining their business and operational models in an ever changing landscape and this allow them to seize new opportunities and grow their business.

With our deep industry knowledge, we are uniquely positioned to provide strategic, regulatory, tax and business advice and help our clients create value for their organisations.

Ultimately, investors should benefit from equivalent due diligence from the depositary regardless of whether their assets are financial instruments or not