

Exploring the ‘Depositary-Light’ option

By Bill Prew, Indos Financial

Although there are many contenders, the winner of the prize for the most complicated and contentious aspect of AIFMD must surely go to the Directive’s depositary requirements. ADI asked Bill Prew, CEO and Founder of Indos Financial, the independent depositary oversight provider, to outline the ‘Depositary-Light’ option that alternative managers are looking at.



Bill Prew

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The AIFMD depositary requirements are driven by a combination of the domicile of the Alternative Investment Fund Manager (AIFM), the Alternative Investment Fund (AIF) and the approach taken to marketing the AIF. Only EU AIFM managing EU AIF are subject to the full depositary regime (Article 21), whereby a single depositary is required to perform the three core depositary duties of safe keeping of assets, cash flow monitoring and oversight (principally the oversight of valuation, subscriptions and redemptions, compliance with laws and regulations, investment restrictions and leverage). Under this model, the depositary is required to take on the strict liability for loss of financial instruments.

However, EU AIFM managing non-EU AIF and marketing (defined

broadly as at the initiative of the manager either directly or indirectly through a third party) those AIF via private placement as opposed to reverse solicitation (at the initiative of the investor) are subject to a ‘depositary-lite’ regime (Article 36). This requires the AIFM to “ensure one or more entities are appointed to carry out” the three core depositary duties noted previously. Because strict liability does not apply and multiple firms can be used this has been dubbed the ‘Depositary-Light’ model.

To date, the primary focus of depositaries and prime brokers has been to agree the single depositary model for EU funds. Given the potential liabilities depositaries are being required to take on this is perhaps not entirely surprising. Even today, three months after the

22 July 2013 AIFMD transposition date, these negotiations are not completely resolved. Against this backdrop, depositary-lite has not received the attention it deserves which is disappointing given the significance of the non-EU hedge fund sector in the context of the overall industry. Managers, many of whom are starting to focus on this area of AIFMD, have reported real frustration about the lack of clarity from many service providers in terms of their depositary-lite solutions, fees and contractual terms.

The majority of UK based managers regulated by the Financial Conduct Authority (FCA) will need to apply to the FCA to vary their regulatory permissions to become an AIFM. The FCA has stated that in order for managers to be certain of receiving

Continues on page 16 >>

Exploring the ‘Depositary-Light’ option

Continued from page 15

Managers should think about the inherent conflict of interest presented by the model where a depositary forms part of the same group as the administrator

their AIFM authorisation by the 22 July 2014 deadline for compliance with the AIFMD, they should submit their variation of permission application (VOP) no later than 22 January 2014. Most managers appear to be working towards this date. Managers seeking to market their funds through private placement will need to identify their depositary-lite providers in their VOP. However, in reality most managers will only want their authorisation as an AIFM to become effective on 22 July 2014. Whilst this will give the depositary industry time to on-board the large number of funds expected to be subject to the new rules, it does mean there is only a short period of time for managers to identify their providers prior to 22 January.

Turning to depositary-lite itself, two models have emerged. Many existing depositaries are proposing a ‘one stop’ **single firm model** whereby they will perform all three depositary-lite duties. In reality for these firms, the depositary model for EU and non-EU funds

doesn’t differ greatly except for the potential increased liabilities they face from EU funds. There are obvious benefits to depositaries from offering the single model including consistency of operations and higher potential revenues.

The second model is the **multiple-firm model**, where the duties are performed by a combination of the existing prime brokers and custodians (safe keeping of financial instruments), existing administrators (cash flow monitoring and record keeping of other fund assets such as derivatives) and an oversight provider performing the oversight duties. Today, the prime brokers and administrators broadly perform the safe keeping and cash flow monitoring duties required under the directive. The main action for managers is to identify an appropriate firm to perform the oversight duties.

Whilst many depositaries are offering the single model, by far the majority of managers will have a strong preference for the

multiple-firm model. Put simply, many managers don’t want to pay for duplication of functions already performed today. With investor focus on fund expenses and in a challenging return environment, the issue of cost-effectiveness is key. In the multiple-firm model, funds really ought to only paying for the oversight function since the safe keeping and cash flow monitoring duties are largely already performed today. Oversight should start at 2 basis points which reduces as assets grow, with strong arguments to cap fees at a certain level depending on the complexity of the strategy, fund structure and terms. The single model is naturally going to cost more since the depositary is taking responsibility for safe keeping and daily cash flow monitoring. Some reports suggest the costs for the single model could start as high as 5 basis points. In addition, faced with many other AIFMD and other regulatory challenges, managers prefer a model which requires the least amount of operational change. They also want to retain flexibility and the maximum level of competition between service providers, both of which are achieved by the multiple model.

Continues on page 17 >>

Exploring the ‘Depositary-Light’ option

Continued from page 16

Other considerations include:

Independence

Most existing depositaries will only act where an affiliated entity is the fund administrator. Since a core element of the depositary-lite regime is oversight over the fund valuation function, consideration should be given to the inherent conflict of interest presented by this model. With the continued focus in the industry on governance, best practice and management of conflicts of interest, an independent model wins hands down over the affiliate model. At Indos Financial, we will provide managers with an independent alternative to the established affiliated depositary model, and perform genuine arms-length oversight and provide full transparency on the results of our work to managers and the fund board.

Scope of activities

Many established trustee models simply involve a monthly review of investment guideline compliance and a single annual NAV review.

Depositary-lite, when implemented well, does not need to be a ‘tick-the-box’ exercise, but a solution which will add real value to investors

We believe this provides little value to investors or managers. By leveraging technology and using experienced staff, Indos Financial will therefore seek (where possible) to perform daily investment guideline monitoring and a regular monthly NAV review. Both will add real value compared to other models which exist today.

Regulation

The FCA requires any UK firm performing one or more of the depositary-lite duties (such as Indos Financial) to be regulated as an ‘Article 36 Custodian’. The regulatory status in Ireland, where the majority of fund administration for non-EU funds is performed, remains unclear although there are indications the Central Bank of Ireland may view the oversight function, in particular, as not being

a regulated activity. Given the similarities between the oversight function and a traditional trustee role (a regulated activity for around 22 trustees based in Ireland), this seems surprising. As an FCA authorised firm (Indos has recently received ‘subject to’ authorisation from the FCA), we will also be subject to the high standards set for firms undertaking fiduciary activities. We expect managers and investors will take comfort from solutions provided by a regulated firm.

In summary, depositary-lite, when implemented well does not need to be a ‘tick-the-box’ exercise, but a solution which will add real value to investors. ■



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