

# AIFMD Hedge Fund Depositary Due Diligence Assessment Checklist November 2013

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<b>COMPLETED BY THE FOLLOWING AIFM:</b>	
AIFM:	
For the following AIFs:	
Comments:	

<b>COMPLETED FOR THE FOLLOWING DEPOSITARY:</b>	
Full Legal Name:	
Address:	
Telephone:	
Website:	
Contact Name and email address:	

Many EU hedge fund managers will need to comply with new requirements under the Alternative Investment Fund Managers Directive (AIFMD) to appoint a depositary. The exact requirements will depend on a combination of the domicile of the managers, their hedge funds and how they are being marketed. The requirements can be broadly summarised as follows:

1. All EU-domiciled Alternative Investment Funds (AIF) managed by EU Alternative Investment Fund Managers (AIFM) are required to appoint a single depositary (Article 21);
2. EU-AIFM managing non-EU AIF must comply with the 'depositary-lite regime' (Article 36) if the AIF is being marketed to EU investors through private placement; and
3. Non EU-AIFM managing either EU or non-EU AIF are subject to Article 42. Whilst Article 42 does not impose any depositary requirements, some countries (including Germany and Denmark) are imposing a depositary-lite requirement in order to market these funds into their countries.

Regardless of the regime which will apply, hedge fund managers will need to undertake due-diligence over their depositary providers. In particular, UK managers will need to provide a summary of the due diligence undertaken in their AIFMD Variation of Permission applications to the Financial Conduct Authority, and be in a position to share further details of the due diligence undertaken on request by the FCA.

This checklist has been designed to assist managers undertake the necessary depositary due diligence. Introductory text has been included in each section and a series of more detailed questions follow. To keep the document to a manageable and practical size, the introductory text is summary in nature and does not purport to be legal advice and should not be relied on as such.

In the context of the depositary-lite regime, the term Depositary within this document would apply to any entity undertaking one or more of the depositary-lite duties of safe keeping of financial instruments, cash flow monitoring and oversight. In practice this could therefore include prime brokers, custodians, fund administrators and depositaries, as relevant, for the respective duties they would undertake.

On an on-going basis managers will also have a general obligation to monitor the performance of their depositaries and undertake periodic due diligence updates.

Some depositaries may provide a due diligence questionnaire which may address a number of the items in the checklist.

## 1. REGULATORY AUTHORISATION

Depositaries which act for EU-AIFM managing EU-AIF will need to appoint a single depositary and this depositary will need to be domiciled in the domicile of the AIF.

The depositary requirements for EU AIFM managing non-EU AIF and subject to Article 36 ('depositary lite') differ between EU Member State. In addition, different regulators have different requirements for firms undertaking the depositary-lite duties. Any UK firms will need to hold an FCA authorisation, whereas overseas firms may not be subject to regulation or the position (at the current time) may be unclear.

Firms should be able to clearly explain the regulatory framework which applies to their proposed activities.

Information Requirement	Depositary Response	Checklist
Depositary legal entity name.		<input type="checkbox"/>
Country of domicile of the Depositary.		<input type="checkbox"/>
Is the Depositary a regulated firm?  If so, by which regulator and what regulatory authorisation does it hold? Does this authorisation enable the firm to undertake the necessary depositary duties?		<input type="checkbox"/>
Is the Depositary utilising an AIFMD transitional provision during which period it may act as AIFMD Depositary? If so, has it submitted a variation of permission application to its regulator and when does it intend to obtain its authorisation?		<input type="checkbox"/>
Has the Depositary been subject to any regulatory sanction?		<input type="checkbox"/>
Has the Depositary been subject to any past claims where the Depositary was found to have been negligent?  What circumstances gave rise to the claims and have procedures been enhanced as result?		<input type="checkbox"/>

## 2. FINANCIAL STRENGTH

Depositaries for EU AIFM managing EU AIF are required to take on the ‘strict liability’ for loss of financial instruments held by them in custody. This means a depositary is obliged to return identical financial instruments or the corresponding amount to the AIF (or the AIFM acting on behalf of the AIF) without undue delay, even if the instruments were custodied by a sub-custodian. The depositary will 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”. Where the assets are sub-custodied, the depositary may be able to contract out of this liability if it has complied with all prescribed obligations in the AIFMD and there is an ‘objective reason’ for the delegation. Different depositaries are taking different positions in relation to the discharge of liability.

In the case of “other losses” which the AIF or its investors may suffer, liability will flow if there is a “negligent or intentional” failure on the part of the depositary to comply with its obligations under the Directive.

Depositaries which form part of broader financial services group will be perceived to offer ‘deep pockets’ protection, but how is the depositary unit capitalised and what parent guarantees exist to back up the depositary in the event of their negligence?

Independent providers may not have the same deep pockets protection, but if regulated, will be required to maintain minimum levels of regulatory capital and should maintain adequate professional indemnity insurance.

Information Requirement	Depositary Response	Checklist
Name of the Depositary’s parent entity (if any).		<input type="checkbox"/>
How is the Depositary capitalised and what parent guarantees exist to back-up the depositary in the event of their negligence?		<input type="checkbox"/>
What levels of Professional Indemnity Insurance does the Depositary maintain?		<input type="checkbox"/>
What level, if any, of regulatory capital is the Depositary required to maintain?		<input type="checkbox"/>

### 3. GENERAL MATTERS

The primary responsibility of the depositary is to act fairly and in the best interests of investors.

Depositaries should also be able to articulate the experience they have of hedge fund strategies and how they will add value to the AIFM and the AIF.

The Depositary should also be able to articulate how it manages the potential conflicts of interest which exist in the most common industry model whereby a depositary oversees an affiliated entity performing an AIF's fund administration.

Information Requirement	Depositary Response	Checklist
Is your business strategy focused on servicing any particular sector(s) of the alternative investment fund market?		<input type="checkbox"/>
Briefly summarise the key differentiating factors between the Depositary's services and those of your competitors, and how will the Depositary add value to the AIFM and the AIF?		<input type="checkbox"/>
Does the Depositary offer a service independent of other custody and administration services to non-existing clients?		<input type="checkbox"/>
Is the Depositary independent from the fund administrator?		<input type="checkbox"/>
Where the Depositary will oversee an affiliated fund administrator, how does it manage the potential conflicts of interest presented by this model?		<input type="checkbox"/>
What experience does the Depositary have with complex derivatives and complex hedge fund strategies?		<input type="checkbox"/>
What systems does the Depositary use to perform its activities (both in terms of workflow management and automation of depositary duties)?		<input type="checkbox"/>

Information Requirement	Depositary Response	Checklist
<p>Does the Depositary have any strategic alliances with or dependencies on, other organisations in relation to your service?</p> <p>If so, please outline these and identify their nature.</p>		<input type="checkbox"/>
<p>How transparent will the Depositary be about the results of its work?</p>		<input type="checkbox"/>
<p>How will issues be escalated and in what kind of circumstances would issues be escalated to the board of the AIF and, potentially, regulators?</p>		<input type="checkbox"/>
<p>What reporting will the Depositary provide to the AIFM and the AIF Board? How frequently will this be provided? Please provide an example report.</p>		<input type="checkbox"/>

## 4. OPERATING MODEL

Different depositaries will have different operating models and service levels. In part these are driven by different regulatory requirements. Key areas include frequency of reviews around investment guideline monitoring, fund valuations and how depositaries meet the enhanced AIFMD cash flow monitoring requirements. Depositaries should be transparent about the procedures they will perform and their frequency (daily/ weekly/ monthly/ quarterly or annually). Depositaries should summarise their procedures and, in particular, the frequency of operation.

Information Requirement	Depositary Response	Checklist
Cash Flow Monitoring: Article 21(7) (of particular note – will the depositary undertake independent daily reconciliation or seek to rely on reconciliations performed by the administrator?)		<input type="checkbox"/>
Safekeeping of Assets: Article 21(8)(a)		<input type="checkbox"/>
Record Keeping for Non-Custody assets (“Other Assets”): Article 21(8)(b)		<input type="checkbox"/>
<u>All of the Article 21(9) requirements:</u>		
Oversight – Subscriptions and Redemptions		<input type="checkbox"/>
Oversight – Valuation of Shares/Units		<input type="checkbox"/>
Oversight – Compliance with Laws and Regulations (including Investment Guideline Monitoring and AIFMD Leverage Monitoring)		<input type="checkbox"/>
Oversight – Timely Settlement of Transactions		<input type="checkbox"/>
Oversight – Distributions		<input type="checkbox"/>
Will the Depositary delegate any of the above activities? If so provide details.		<input type="checkbox"/>
Does the Depositary provide an independent controls assurance report i.e. ISAE3402 report? What exceptions were noted in the most recent report and how have they been addressed?		<input type="checkbox"/>

## 5. ON-BOARDING

As a general rule, prior to AIFMD, EU funds have been subject to a trustee or depositary requirement of some kind, and therefore these provider relationships will need to be adapted to become AIFMD compliant.

However, the depositary-lite requirements, notably the oversight duties, which apply to EU AIFM of non-EU AIF are new and a large number of AIF's (potentially 750 +) will need to be on-boarded by depositaries by 22 July 2014. Given this potential volume and hard deadline, how depositaries approach on-boarding is very important.

Information Requirement	Depositary Response	Checklist
Does the Depositary have a dedicated on-boarding team or is the process run by the 'business as usual' team?		<input type="checkbox"/>
How long would the Depositary expect the on-boarding process to take?		<input type="checkbox"/>
The Depositary should outline the high level steps and timeline for take on.		<input type="checkbox"/>
Is the Depositary subject to any capacity constraints in terms of its ability to on-board AIFMD business?		<input type="checkbox"/>

## 6. COSTS

Since the depositary requirements are to offer protection to investors, the costs will typically be charged to the AIF. Depositaries should be transparent about their fees and, in particular, minimum fees at lower AUM levels, how they will change as assets increase, and whether they will cap their fees.

Information Requirement	Depositary Response	Checklist
What is the Depositary Charge Sheet? How will fees change as AUM increases/ decreases? Are there any minimum fees?		<input type="checkbox"/>
Does the Depositary consider fee caps or fixed fees depending on complexity of strategy?		<input type="checkbox"/>
Will the Depositary charge a set up fee?		<input type="checkbox"/>
In relation to depositary-lite: Where a prime broker performs Article 21(8)(a) or an administrator performs 21(7) and 21(8)(b), will they charge clients additional fees?		<input type="checkbox"/>
Will the fees increase if the AIFM introduces new feeder funds and/ or new share classes or other life cycle events for an existing AIF?		<input type="checkbox"/>

## 7. LEGAL TERMS

As noted in section 2, different liability provisions apply to depositaries of EU AIFM of EU AIF compared to the depositary-lite regime. In all cases however, depositaries should contract to a negligence standard of care. Market practice is for depositaries to not seek to cap their liability.

Information Requirement	Depositary Response	Checklist
Please provide a copy of the Depositary Legal Agreement.		<input type="checkbox"/>
Please confirm the liability provisions/ standard of care. Specifically note and explain the reasons for any liability caps.		<input type="checkbox"/>
Will the depositary seek to discharge its liability for loss of financial instruments to the prime broker(s) and, if so, on what grounds (i.e. depositaries must have an ‘objective reason’)?		<input type="checkbox"/>
Where a single depositary is appointed and the depositary appoints prime broker(s) as sub-custodian(s), has that depositary finalised legal agreements with the prime brokers?		<input type="checkbox"/>
Will the Depositary agree and maintain a Service Level Agreement with the AIFM, Administrator and/or the Prime Broker? Please provide a draft SLA.		<input type="checkbox"/>

## 8. FUTURE DEVELOPMENTS

There are expected to be on-going regulatory changes over the next few years which will impact how depositaries service their clients.

In particular, for EU AIFM of Non-EU AIF subject to the depositary-lite regime, if the AIFMD marketing Passport is extended to non-EU AIF, a single depositary will be required and the full Depositary regime which applies today to EU AIF's will apply. What this means in practice is depositaries will need to be domiciled in the domicile of the AIFM (in most cases the UK) or the AIF (in most cases, Cayman Islands). Many entities undertaking the depositary-lite duties are expected to be Irish firms which will not meet these requirements going forward. This is therefore one example where firms should be able to explain their plans to adapt their businesses such that a change of provider may not be required in due course.

Information Requirement	Depositary Response	Checklist
Explain your strategic commitment to the AIFMD depositary market and how this fits within the overall context of your organisation's activities.		<input type="checkbox"/>
What regulatory changes does the Depositary expect to have an impact on its operations over the next five years and what plans does it have to adapt its business and operating model?		<input type="checkbox"/>